PROBLEMS OF MONETARY POLICY IN UNDER-DEVELOPED COUNTRIES WITH SPECIAL REFERENCE TO INDIA.

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Contents

Preface

Few problems to-day would be as pressing as the problem of improving the economic well-being of the people of under-developed countries. But few problems would be more difficult also. In particular, the Governments of under-developed countries are exercised over how a speedy economic development can be combined with the equally important requirement of price stability. To that end, all thoughts of economists interested in growth are being naturally directed at present. It will be too presumptuous for me to claim that this work offers any solution to this vexed issue. But if it has resulted in even identifying some of the basic considerations involved, my labours would have been amply rewarded.

It will generally be agreed to that the task of a person writing on monetary policy is by no means enviable. With monetary theory being 'a theory of output as a whole' and not 'as something so to speak separate from the general theory of supply and demand' his sphere of interest enlarges so much that he may easily stray into what seem to be rather irrelevant discussions. I would, therefore, crave the indulgence of the reader if at any place in this work I appear to him as not being very directly concerned with monetary policy.

There is another matter for which I will request for his indulgence. There is, in this work, no discussion whatsoever of the international aspects of an under-developed economy's monetary policy problems. I do not think I can offer any justification for this omission except that with the inclusion of that discussion,

the already wide range of my subject would have become unmanageably wider.

As is well-known, while the disease of all under-developed countries is the same, namely, economic backwardness, they make quite a heterogeneous group of patients. Our own study, however, relates to only such of them as are suffering from what they call 'population explosion'. Even here there is no homogeneity, and since most of our arguments and conclusions have been derived from the Indian experience, this could well be a limitation upon their general or universal applicability.

So far as the technical presentation of the thesis is concerned, I have naturally taken care to avoid faults but they might still have crept in. I hope to be forgiven if on account of any such faults, the get-up of the thesis does not come up to some western standards which are said to be very high.

It would obviously be difficult to complete a work of this kind without the help and co-operation of friends and well-wishers. Amongst those who kindly gave me time and discussed my problems at Cambridge, where I had the privelege to be as a visiting economist for a year, the names of Professor E.A.G. Robinson, Mrs. Joan Robinson, Mr. Nicholas Kaldor and Mr. Maurice Dobb need a special mention. To Professor Robinson who spared the maximum time for me and with whom my discussions were particularly rewarding, my debt is greater than I can describe. I am also deeply indebted to Professor J.K. Mehta, former Head of the Department of Economics, Allahabad University and my adviser, who has been to me as indeed to all his pupils a source of the highest inspiration one can look for in one's teacher or adviser. My debt

to Professor P.C. Jain, present Head of the Economics Department, Allahabad University is also quite considerable. He has helped me in ways more than one and his suggestions and constructive criticisms have been highly valuable for me. To my friends Shri S.L. Parmar, Dr. B.N. Asthana and Shri J.S. Mathur on whose time and advice I drew more liberally than I should have been entitled to, I am particularly grateful. But for their constant interest and encouragement, the submission of this work would have been greatly delayed. A word of thanks is also due to Shri S.C. Chaudhary, Economic and Statistical Adviser, Union Ministry of Food and Agriculture, Shri P.D. Srivastava, Joint-Director, Department of Extension and Shri S.P. Dhar of the C.S.O. without whose help and cooperation, obtaining some important data for this thesis would have been a very difficult job indeed. I am thankful to Shri S.K. Mukerji, Managing Editor of the Indian Journal of Economics for permitting me to use here my article entitled 'Under-developed Areas - An Economic Perspective'. I must also express my thankfulness to the typist, Shri B.B.L. Bhargava whose efficiency and hard work have enabled me to complete my work sooner than would have otherwise been possible.

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P E R S P E C T I V E S

CHAPTER I

PERSPECTIVES

It is desirable for the discussion of economic problems relating to under-developed areas that we have a perspective to view them from. That there is awareness of some difference between the developed and under-developed economies is true but where precisely that difference lies is not treated as important. Some avoid worrying about it lest they might appear as being interested in definitions which in their view should be tabooed in economics. Others would like to say that the difference between developed and under-developed areas is one of degree only, not of kind. This in fact seems to be the majority view.

The interpretation, however, that the difference is one of degree only does not take us far because even the difference between light and darkness can mean a difference of degree only. There is nothing wrong in regarding an under-developed areas as one which has a low level of income, national as well as per capita, and a poor standard of living but that takes us to the symptoms only, not to the disease. Moreover, such a statement, relatively understood, could imply any country, except the top one, to be under-developed.

The best way to me seems to be regard under-developed areas as places where, on being left to themselves, the determinants of economic development fail to harmonise effectively for purposes of growth over a long period.

There are thus two vital facts worth remembering: one, that the forces of development tend to be lost or neutralised; and two, that the whole process is to be viewed form a long rather than a short period angle.[1]

Why is it that the forces of development have tended to go waste or neutralise? Because, and this brings out the essential point of the statement made above, left as they were to themselves, they could not find that mutual spontuneous response from each other which was the real reason behind the economic development of the western countries. It is a well-known fact that western economic development has not been the function of a single factor but of a combination of a large number of harmonious factors at the same time. It is absence of this automatic harmony which has made certain countries poor while it is the presence of this harmony

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1. "For countries with current low income levels (less than $100 per capita), any appreciable growth in per capita income during the last century is unlikely to have occurred...... growth of total national income during the last century must have also been at much lower rate in most countries currently under-developed than in countries now at the upper levels of the income pyramid." Simon Kuznets in a paper on Economic Progress discussed at a Round Table Meeting of the International Economic Association. 28th Aug. to 2nd Sept. 1953.

A more specific statement is made in the following observations of Shri Iengar, the then Governor of the Reserve Bank of India at a discussion of the Twelfth Annual Meeting of the I.M.F. and I.B.R.D.

"Some 40 years ago, an able and imaginative Englishman working in India, conducted a survey of economic conditions in a village in Bombay State. He was horrified at the poverty disclosed by his survey. This same village was re-surveyed a couple of years ago by one of our research Institutes. The conditions of the village lent themselves admirably for such a survey, for it was like the majority of Indian villages, away from the main road and the tenor of its simple agricultural economy had not been disturbed by the intervention in the neighbourhood of any large industrial establishment. According to the survey, time had stood still in this village. During a period of nearly 40 years, poverty had continued its malevolent supremacy and the people lived in the same primitive conditions as their fathers had done. This would be true of tens and thousands of villages in the Indian sub-continent.....". Reserve Bank of India Bulletin, November 1957, p. 1089.

which has made certain other countries prosperous.[2]

Some economists would make the will for development as the main line of division suggesting thereby that the under-developed areas' lack of such a will is the main cause of their trouble. There is, however, not much evidence to support this contention. Several of the areas that are now backward -- China, India, Egypt, Babylonia, Persia had attained a high level of economic development in the past.[3] What this proves, therefore, is not that the people in these areas have lacked the will for economic development but that the hurdles cropping up in their way later made their will almost entirely ineffective.

Does not a large population account for their backwardness? Yes, but only in some cases. For there are many under-developed areas which are sparsely populated. As for others, the correct thing would be to make a combination of population with other factors and not population alone, accountable for backwardness.

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2. "The conjuncture of growing supplies of land, labour and capital made possible the expansion of industry; coal and steam provided the fuel and power for large-scale manufacture; low rates of interest, rising prices and high expectations of profit offered the incentive. But behind and beyond these material and economic factors lay something more. Trade with foreign parts had widened men's views of the world and science their conception of the universe: the industrial revolution was also a revolution of ideas. If it registered an advance in understanding of, and control over Nature, it also saw the beginning of a new attitude to the problems of human society"; T.S. Ashton. The Industrial Revolution, 1760-1830, p. 21.
3. Conditions of Economic Progress: Colin Clark (2nd ed.). 542

The same would be said about shortage of resources. If we are not to fall in the trap of the obvious fact that there is no country in the world which can claim to have enough resources, we have to interpret this shortage in relation to the rest of the economy and not as an isolated factor.[4]

Some economists have tried to draw the line on the basis of technical progress. Without going into the rather philosophical question of the factors which cause technical progress, it can be maintained that by itself technical progress cannot be a guarantee for economic development. The fact that in some countries of the world such a development has coexisted with technical progress does not prove that technical progress alone is the cause of it. The cause may actually lie in favourable responses from several directions at the same time, technical progress representing only one such though a very important direction.[5]

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4. It is, for instance, suggested by some economists that under-developed areas have not developed because they lack capital equipment. Their point of view is correct as far as it goes. But capital equipment alone would not do. Additional equipment must be matched by a commensurate amount of raw materials just as the newly employed must have food and consumers' goods. It is doubtful if the Industrial Revolution in England would have been successful without surplus agriculture; that is, without capital equipment having been matched by an almost automatic supply of raw materials and food.
5. "The great growth of capital in the eighteenth and nineteenth centuries in Europe was due not to mechanical forces but to the evolution of new patterns in social relationships. It was due to the emergence of new types of social activity.... To repair and maintain; to think of tomorrow, not only of today; to educate and train one's children; to prepare oneself for new activities; to acquire new skills; to search out new contacts; to widen the horizon of individual experience; to invent, to improve, to question the 'dead hand of custom' and the heritage of the past - in all these and not in mechanical calculations or mechanical regimentations lay the causes of capital accumulation. For indeed capital was but 'accumulated' in the ledgers of the counting house, it was embedded in the general stream of changing activity, in world-wide migration,

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Now against the view that under-developed areas are basically those where forces of development could not harmonise by themselves, it might be argued that sometimes even in the developed countries, certain forces have been out of tune with certain other forces. Yes, but the question is whether the lack of harmony between such forces has been chronic or short-lived. The point being stressed here is that in under-developed areas the determinants of economic development have failed to achieve harmony over a long period and the main cause for that is their having been left to the mercy of the 'invisible' hand. In developed areas, such a state of affairs has only been experienced in the short period. Where long period lack of harmony has been referred to, as for instance, in Harrod's theory of growth, the intention is not to consider determinants of economic development like food, education, technology, population, institutional and social framework getting out of tune with each but some other factors, possessing more or less a short period significance. Harrod's purpose being to explain why economic development in capitalist economies tends to be unstable, it is necessary for him to assume a continuous process of development for his analysis.[6] And one cannot reconcile such an assumption with the determinants of development themselves getting out of tune with each other.

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in the cooperant bonds of commerce and mutual confidence and in painfully created new aptitudes of action and responsibility'.
5. Herbert Frankel, The Economic Impact on Under-developed Societies, _Essays in International Investment and Social Change_, Oxford (1953), p. 69.

6. It is on this same assumption that the Marxian disharmony would also rest.

Now lack of harmony in developmental forces need not shut out all progress. But it does shut out a substantial and sustained progress for a long time and can as much take an economy backward as it can keep it stationary.

There is stationariness when the favourable change in one particular force is neutralised by an unfavourable change in other forces as when increased cultivation synchronises with a rise in population and agriculture is unable to build up a surplus. This is the familiar case of a vicious circle which a large number of economists including Professors Ragnar Nurkse[7] and H.W. Singer[8] have convincingly made out. There is a movement in the backward direction when an unfavourable change in one particular force leads to similar changes in other forces as when a rise in population by pushing down wages might hold up technical progress and lead to 'Malthusian misery',[9] or when increasing consumption reduces saving, raises prices and confuses efforts at capital formation. In his theory of circular causation, it is some such picture which Professor Gunnar Myrdal has in mind.[10] However, all under-developed areas do not fit into Professor Myrdal's picture. Some instead of going backward have in fact come up a little though their forward movement, because it did not have the backing

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7. Problems of Capital Formation in Under-developed Countries: Ragnar Nurkse, 1957, pp. 4, 5.
8. 'Economic Progress in Under-developed Countries', an article in Social Research, March 1949: H.W. Singer.
9. Accumulation of Capital: Joan Robinson, p. 95.
10. Economic Theory and Under-developed Regions: Gunnar Myrdal, Vora & Co., May, 1958, pp. 23 to 34.

of mutually responsive development forces, has only been apologetic. In fact, a substantial part of that improvement might have just been an incidental fact resulting from the prosperity of some developed area.[11] Thus while not being wrong, Professor Myrdal's theory of "circular causation" does not describe individually all the various types of under-developed areas that are there. But as an over-all account of such areas put together vis-a-vis the developed ones, it may not be easily questioned. The difference between our approach and Professor Myrdal's should be obvious. We are arriving here at a perspective with reference to the internal setting of a typical under-developed economy whereas Professor Myrdal is concerned with the international setting of such economies lumped together.

Why can not we as a substitute for our approach join Professor Ragnar Nurkse and say the simple thing that an under-developed economy is poor because it is poor? Is it really necessary to refer to determinants of development failing to harmonise and so on? It is, because, whereas the simple statement does not mean anything more than what we can see on the surface, our statement goes deeper and explains not only why there is poverty in some areas of the world but also, at the same time, why there is

11. "The dynamic factor in that century (nineteenth) was the growth of industrial countries; what happened in primary producing countries, by way of increased production of primary products and increased trade, was merely by way of reaction to disturbances originating in industrial countries....."
Professor Arthur Lewis; Economic Survey - 1919 to 1939.

prosperity in the other areas. Further, it enables us to establish that, between these two types of areas, the difference is fundamental and not one of degree only. Whereas in some parts of the world, the forces of development, left largely unaided have been assisting each other, and making for progress in the long run, in others, left that way, they have been neutralising and in many cases defeating each other in the long run; whereas in some parts of the world they have signified a single line of advance[12] with just occasional deviations, in others they have signified a series of vicious circles with their centres moving sometimes even in the backward direction. It is doubtful if this difference is clearly brought out either in Professor Nurkse's unquestionably correct statement or in other descriptions based upon the recognition of the existence of vicious circles. The difference is important in so far as it points to the fact that the practice of allowing a free play to the economic forces which put the West on the rails has prevented under-developed areas from constructing any rails of their own; it has rather led to the cropping up of a series of hurdles which require more than the 'invisible hand' of the market to take them through. The economic structure used to a single line of advance will not do for a situation of vicious circles.

Let it, however, be stated here that this is not a condemnation of a system of private enterprise as such. Evidently it has been successful in some parts of the world. But the fact that it has succeeded in a certain background should not be lost sight of. It

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12. Towards a Dynamic Economics: R.F. Harrod, 1960, p. 88 ff.

will not be convincing to argue that this background was consciously and deliberately created. To do so would be to knock the base out of a system which from a long period point of view, at any rate, has allowed itself to be guided by the 'invisible hand'. Nor will this be convincing that since some countries of the world have gone through the historical transition of a capitalistic economy, others must also pass through a similar transition. An economic structure resulting from the circumstances of history of a few countries need not fit into the circumstances of all. The under-developed areas may very well require a frame-work which is very different from that of the West. To suggest that the difference between them is one of degree only is to make us ignore this very important fact. The economic frame-work of the West used to long period harmonies is at best fit for tinkering with economic forces here and there but not for cutting vicious circles and harmonising a chronic conflict between the determinants of economic development.

Another significant fact pointing to the need for a structural change is the feeling of suspense which either actually dominates or is threatening to dominate the psychology of private entrepreneurs in many under-developed areas today.

Now a feeling of suspense is not the usual feeling of uncertainty from which the entrepreneur derives his name in economics. The usual type of uncertainty is in regard to the prospect of profit and loss in business. But this one, which is deeper, is in regard to the survival of enterprise as an instrument of personal good. The uncertainty experienced by an American entrepreneur will come under the first category whereas the uncertainty

experienced by an Indian entrepreneur might come under the second. As can be seen, the difference will have a decisive bearing upon entrepreneural attitudes. Whereas all that may be required for the expansion of private business in U.S.A. is a prospect of profit commonly understood, the mere hope of a profit may not induce an Indian entrepreneur to a similar expansion.

The entrepreneurs' doubt in regard to the survival of their entreprises as instruments for their personal good can be attributed to a number of factors not the least important amongst which is the desire of the people in the under-developed areas to rise to a status of approximate equality with the developed areas of the world. Why cannot private entreprise alone do this for them? Because it has not been able to do this so far and the situation is now too complicated for it to tackle. Moreover, little reliance can be placed upon free forces when the desire is to have a definite level of economic development. Assuming that the incongruities between the developmental forces have somehow been resolved for private entreprise, what hope is there that the gap between the incomes of the developed and under-developed areas would be bridged to a respectable extent by the 'invisible hand'? Few people will question the fact that development resulting in a free enterprise economy is erratic and unpredictable. And if there is one risk which people in under-developed areas do not want to take, it is in regard to their economic development. In fact, more important than having a definite sort of economic development, is having it within the shortest possible time. This again, a private enterprise system in the midst of the prevailing

peculiar conditions of the under-developed areas, may not offer.

It may be asked here why the under-developed areas should be in so much hurry about their development, when the West itself took several centuries to reach its present level of prosperity.[13] There is every possibility that actual economic development may turn out to be slower than desired. But that does not mean that it will be right to desire a slower economic development. In fact, with international economic inequality getting worse with the passage of time, to desire the speediest economic development is the only sensible thing for the under-developed areas to do.

Increases in Real National Incomes 1951-59.

Country	Percent growth in income per year	
	Total	Per capita
Japan	8.3	7.2
Jamaica	8.9	6.9
West Germany	7.3	6.1
Trinidad and Tobago	9.1	5.9
Algeria	8.0	5.7
Austria	5.8	5.6
Puerto Rico	6.1	5.5
Greece	6.2	5.2
Italy	5.7	5.2
Israel	9.0	5.0
Rhodesia & Nyasaland	6.8	4.1
The Netherlands	4.6	3.4
France	4.2	3.2
Turkey	5.9	2.9
Switzerland	4.1	2.8
Sweden	3.4	2.8
The Phillipines	5.8	2.5
Indonesia	4.2	2.2
The United Kingdom	2.6	2.1
Ireland	0.9	1.6
Thailand	4.8	1.3
India	3.3	1.3
United States	2.8	1.1
Canada	3.7	0.9
Ceylon	3.0	0.4
Pakistan	2.3	0.4

Source: B.R. Shenoy's article in Supplement to Capital, 19th December, 1963, p. 39.

13. "At the end of the First Five Year Plan in April, 1956, the (continued)

One reason for the entrepreneurs' state of suspense not appreciated outside their countries, is the combination of a growing awareness amongst the people of their economic and political rights and a colossal inequality of personal incomes.[14] Each fact individually may not matter but a combination of the two can always be important. It is especially so in the present background of communist propaganda and expansion. It may not be rational but it is nevertheless true that much of the sting of a man's poverty is taken out if he finds that everybody else is more or less as poor as he himself is. Equality for such men is a much stronger psychological force than it is for those who have not known such poverty.[15] But for the same reason, inequality can be an equally strong force in the opposite direction and aggravate dissatisfaction and grouse against the prevailing order to which it will be quite easy to fix a responsibility.

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per capita income in India, per year was $50, less than one dollar per week. And all that is contemplated by the Second Plan is to raise it to about $ 60 in five years, or a dollar and 15 cents per week. With the successive Plans that are to follow, the hope is, in a period 25 years, to double the income. That is to say, in about 20 years from now, all that we are hoping to achieve is a per capita income of $ 100 per year. I do not think anybody will, in all conscqeience, regard this as an over-ambitious target", H.V.R. Iengar, op. cit.

14. Simon Kuznets in American Economic Review, March, 1955, p.25

15. "..........per capita income in a large part of the world is significantly lower than it was in the developed countries prior to their industrialisation; and in the latter, there must have been some rise in per capita income even before the push given by industrialisation", Simon Kuznets, in a paper on Economic Progress at The International Economic Association Meeting, 28th Aug. to 2nd Sept. 1953.

An example of how we ignore this fact is the advocacy of development by inflation in these areas. In economies where there is a high level of employment, where wages are not burdened with the deadweight of a growing population and where price diffusion is not hampered by too much immobility, inflation may not accentuate real income inequalities. But in under-developed areas, it is almost certain to do that. For they are characterised by the existence of innumerable frictions and barriers in the way of a quick price diffusion. The stock argument that the question of sharing income should follow rather precede economic development ignores what is so obvious that poverty like misfortune can and should be shared and that a handful of people have no right to be comfortable when almost everybody else is miserable. In fact the argument loses all its force when the current socio-political conditions of these areas are kept in mind. Moreover, the basic thing is not that it is the lack of a 'fat' profit or income with some chosen people which is holding back economic development; it is that the barriers are too many and sometimes too high to be crossed by them with the help of their old formulae.

Now the average man's tendency, supported by the 'demonstration effect' of communist propaganda and expansion to blame the existing order for his misfortunes, cannot fail to have its effect upon the persons who constitute it. In the past, this average man, in the under-developed areas could be ignored but not now, because now in some immediate or remote way he holds some power. It is a factor contributing to the state of suspense that the extent of this power is not known. Even his government

at many places cannot be treated as a definite reflection of his power and so while government declarations try to safeguard entrepreneurial interests with long period guarantees, the suspense in regard to survival in the minds of the entrepreneurs continues to remain. If in the past such a suspense did not exist in the under-developed areas, it is because the average man had not grown the consciousness which has given him his power today.[16] If in the West it is not seen at this moment, it is because the average man, having enjoyed continued prosperity, may not be dissatisfied with the prevailing order. .

It may be that the lack of enthusiasm for a free economy in under-developed areas is not pointedly aggressive at this moment but it is nevertheless in the air clouding the atmosphere and reducing visibility. What is important is that the entrepreneurs have not been able to assess the darkness of the clouds. Every now and then they urge upon the creation of the necessary 'climate' for investment but what really constitutes this 'climate' is not defined. It looks as if there is something hazy in regard to their future prospects which is inhibiting them but like the famous Shakespearean prince they are unable to decide

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16. "It is quite possible that in under-developed countries of our days.... lack of sympathy with entrepreneurs is greater than in Imperial Russia. And on the other hand, it is more likely that.... values will more readily coalesce with modern anti capitalist sentiments and persuasions and that... such a combination may find effective expression in acts and policies of the Governments concerned." Alexander Gerschenkron, Social Attitudes, Entrepreneurship and Economic Development in Economic Progress Papers and Proceedings of the International Economic Association.

what it is. It is this psychology which we refer to by the phrase 'state of suspense' and which is so obviously different from the 'state of expectation' of typical economic discussions. The latter is a calculation of profit or loss whereas the former is a lack of calculation or better still, a calculation which is being rendered increasingly difficult on account of confusion on the score of the digits themselves.

It may not be easy to fit this view into any straight-jacket of facts because in those under-developed countries where increase in output has taken place, the private and public efforts have been so inextricably mixed that no definite amount of output can be attributed to the 'expansion' of the private sector. But the widening of the activities of this sector which should be attendant upon the type of profit it has been making in these countries is nowhere to be seen. It is quite possible that the unwillingness of foreign private investment to go to under-developed areas is itself partly attributable to a psychology of indecision which dominates the private sector of these areas. When entrepreneurs ask their governments to create the necessary 'climate' for investment, they forget that the clouds are not so much a government creation as the creation of a lack of development, which they have clearly been, not necessarily through their own fault, unable to dissolve.

Now if it is accepted that the expansion of private enterprise in under-developed areas is not being inhibited by an adverse state of expectation of the normal type but by a state of suspense and that the latter would not clear up without economic development, further that this development is not

possible unless the necessary forces are coordinated and harmonised by some instrument other than the 'invisible hand' which has evidently failed in its task, it may not be wise to expect much from the private decisions. In fact there is even the fear that because of a tendency to indecision and consequent stagnation, a typical private enterprise system, may, in course of time, disappear from these areas. It is of the essence of a private enterprise system that it should be dynamic. But for this quality, it could not have created for itself the place it currently occupies in some of the developed economies of the world today. However, in under-developed areas the private enterprise system has not been as dynamic as elsewhere.

It might be interesting to discuss what basic changes in the economic organisation of under-developed economies become necessary, in the light of the above perspective, and whether the same change will do in all of those economies.[17] This, however, is not an easy thing to do. But two uncontroversial statements can still be made: one, that the under-developed areas being a 'mixed bag', a patent economic organisation suitable for all of them at the same time cannot be devised; and two, that

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17. It will be seen that there is a difference between this and the structural change which Professor H.W. Singer suggests in his paper read at a Round Table Meeting of the International Economic Association held between 28th Aug. and 2nd September, 1963. Professor Singer's change only aims at transferring people from the agricultural to the non-agricultural sector, but such a change may remain easily uneffected if it is left to be brought about by 'private' initiative and 'market mechanism'.
   See discussion below.

the new economic organisation in any of them must have an agency not merely for the task of assessing resources and directing them in different uses but also for seeing to it that the directions are effectively carried out. A third statement following as a corollary of the second will be that once this agency has been set up the meaning and the content of the free market will have to undergo a radical change.

It is sometimes suggested that if economic planning is inevitable, it should be directed at correcting structural disequilibrium between the agricultural and industrial sectors by stepping up agricultural production and regulating the growth of population and not by controlling the industrial sector.

Let us examine this argument. Suppose that the ratio of population divided between industry and agriculture in under-developed areas is 30 to 70. If we assume that the working force is 40 per cent of the total population, a cultivator should produce food between 3 to 4 times as much as he himself consumes or which is the same thing as enough food for himself plus 2 or 3 persons. Let us suppose that the structural disequilibrium would be set right by improving the ratio between industry and agriculture to 60 to 40. Then assuming the same percentage of the labour force, the same quantity and quality of food per person, and the same population, each cultivator will have to produce food for as many as 5 to 6 persons besides himself. That is, he will have to almost more than double his food contribution. But population may rise and people may want a greater variety of food. Further, the transfer of people to the industrial sector would require a commensurate increase in the production of raw

materials. And all this will not add up to a merely doubling of agricultural production but to much more.[18] What will such a target require? Evidently a tremendous amount of resources for investment in the agricultural sector. And how can these resources be guaranteed if the other sector is left free to expand at will and in response to the usual inducements? But if we begin to allot resources to the industrial sector thus indicating the directions in which it has to expand in accordance with a pre-determined priority and not with market inducements, is it not the same thing as economic planning? It is, therefore, difficult to see how once the need for economic planning is recognised in the agricultural sector of the under-developed economies, the industrial sector itself can be avoided.

This conclusion is reinforced when the problem of allocation of external resources, which are probably equally if not more scarce, is to be tackled. With worsening terms of trade on the one side and a vast and growing need for foreign capital equipment and technical personnel on the other, an unplanned behaviour of the industrial sector can only succeed in aggravating the situation. The best proof of this possibility was the foreign exchange crisis in India during the Second Plan. It is no secret that if India's private sector could have been made to behave in a less chaotic manner in the matter of the import licenses that crisis would have been partially avoided.

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18. Planning and Economic Development in Asia and the Far East; Agricultural Sector; <u>ECAFE Economic Bulletin</u>, November, 1957.

All this is, of course, on purely economic grounds. But economic grounds may be supplemented by other considerations. There is, for instance, the consideration of equity between the agricultural and the industrial sectors. It is commonly accepted that efforts at increased production would mean nothing unless the peasant is kept back from increasing his consumption at least for some time. In fact if this could be done we might even initiate a multiplier process in the capital formation of these areas.[19] But if the peasant must put up with his lot for some more time, what about his richer partner, the producer in the industrial sector? Are we to insist upon offering him less vexatious laws of income tax, a mild inflation, more profits and greater inducements so that at least his investment could be worth his while? Unfortunately this seems to be quite a common view point on questions of development relating to the under-developed economies today. But all it means is that while producer in one sector of the economy should not be offered the inducement of even slightly increased consumption, the producer in the other sector must have fatter profits. Such an unfairness may be unimportant where agriculture contributes only between 5 to 10 per cent of the national income. But where its contribution is half or more than half, of the total national income and it engages more than 70 per cent of the population, it is most important and its neglect can produce serious consequences. The peasant holds the key to the economic development of under-developed areas at this moment

19. <u>Problems of Capital Formation in Under-developed Countries</u>: Ragnar Nurkse, 1957, p. 40.

and if he has to ignore incentives in the national interest, the producer in the other sector of the economy has no right to insist upon them. Governments and economists have often and not without justification for the critics, rendered themselves liable to the charge of backing vested interests because of an excessive fuss over the offer of incentives to the private sector. When over 70 per cent of the people, underfed and underclothed for centuries, are to be brought under the discipline of a plan, the remaining 30 per cent, many of whom might be overfed and overclothed, can not hope to remain in the ivory tower of a free and profitable market.[20]

It is not a mere chance that in a large number of under-developed countries, the centre of gravity has begun to shift from the market to the planning commission. Economic planning is an old idea; however, its significance to under-developed areas has to be a little differently understood. It is not a choice between stable and unstable development which is how it has been posed in most economic discussions so far; for these areas, it is choice between development and stagnation.

How is a planned economy in the above sense to be differentiated from the familiar mixed economy? Part of the answer lies in the statement just made, namely, that economic planning in

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20. cf. Professor R.F. Kahn: 'Pace of Development' in Challenge of Development, published, Jerusalem, 1958, p. 176. Professor Kahn suggests here redistribution of aggregate consumption involving a cut in the consumption of those already fully employed (this does not exclude capitalist producers of the industrial sector) as a means of achieving sustained growth.

under-developed countries is not to be viewed as a choice between stable and unstable development but as a choice between development and stagnation. The stepping in of the State in the economic life of the people in non-communist developed economies has been basically the result of the recognition of the fact that private enterprise and competition, while initiating and sustaining economic growth, frequently occasion widespread unemployment. That, in a word, was the upshot of Keynes's General Theory. Naturally, the State action in these economies, so far as it has been based on an economic argument, has been little better than a supplement to what may be described as the usual rules of the game. However, economic planning for under-developed countries has not been suggested as a measure of compensation for a deficient effective demand; in fact effective demand hardly seems to be the real issue in under-developed countries. It has, on the other hand, been suggested as the only method of initiating and maintaining sustained growth. This lends a very different colour to State action. It is not just supplementing the usual rules of the game in a more intensive form; it is radically modifying the old rules and even having new ones in their place. This does not necessarily meant an elimination of the private capitalist sector but it does involve a change in its outlook.

Without this happening, economic planning might, as the Indian experience demonstrates, come up against enormous difficulties. Without it, under-developed economies with excessive populations may not be able to put to the best use their only abundant resource, viz., labour.

The question of choice of techniques,[21] while lending itself to treatment in the form of models, cannot be adequately answered unless we have also related it to the role which private capitalist production should play in planned economic development. As Professor Kahn observes: 'Private enterprise, in its search for maximum profits, fails to make allowance for surplus labour except insofar as this is reflected in the wage rates that are paid, and .... this failure implies that it adopts a technique which, from the social point of view, is too capital-using, even if the social objective is to maximise the current rate of accumulation, i.e., it would be desirable to use a technique requiring more labour and less capital'.[22]

As is well known, it was Mahatma Gandhi who had first pointed out that a solution to the question of unused manpower in India really lay in adopting labour-using devices.[23] But, to be consistent, he was also assuming that private capitalists, would cease to behave as mere self-seekers and that they would consider themselves as 'trustees' of their people.[24] The Mahatma was a moralist and believed that the change of heart should be brought about by persuasion. But the significant thing in his solution was his insistence upon a change in the usual capitalist rules of the game.

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21. It is being assumed here that labour-using devices are more suitable for the over-populated under-developed countries.
22. op. cit., p. 167.
23. "Instrument of India's Prosperity": M.K. Gandhi in <u>Economic Thought of Mahatma Gandhi</u>, edited by J.S. Mathur, A.S. Mathur, April 1962, p. 74.
24. Trusteeship Explained, op. cit., pp. 593, 594.

Modern economists, believing that moral approach to economic questions is either extra economic or too idealistic would insist upon such methods as fiscal policy, allocation, control and even nationalisation to achieve this end. But whether we force the private capitalists to behave in a desired manner or we persuade them, the basic idea remains the same, namely, that economic planning in under-developed countries cannot produce the desired result unless the old rules of the game are greatly modified.

The problems of Khadi, a hand made cloth in India which goes begging for buyers despite heavy subsidy and Government support, demonstrate how difficult the task of absorbing surplus manpower becomes if we allow production to continue on the principles of unlimited profit motive, free competition, etc.

This matter of the rules of the game assumes significance in another important context, that of economic development with stability. It is often suggested that for such development fiscal policy itself should be enough. Supposing stability means what it does to an economist, though a layman could easily embarass him by insisting upon a precise meaning of the term, where does the trouble lie? A U.N. Survey observes: 'Inflation in the primary producing countries cannot be explained by any one casual factor. Excess aggregate demand, imbalances between sectoral demand and supply, and various cost factors, including rising import prices and money wages, were all at one time or another, found in conjunction with inflation. Often the various influences were present together; in such cases, it is difficult or impossible to distinguish unequivocally the primary agent in the chain

of causation. Nevertheless one conclusion emerging from the analysis is that excess demand, at both the aggregate and sectoral levels has been a major force in the inflation occurring in primary producing countries.[25] As to why the problem of excess demand at the aggregate and sectoral levels arises, there can be several explanations-budget deficits, increased private expenditures, export surpluses, inadequate supply of consumers' goods etc. But as the Survey observes: 'The first step in a programme of economic development which pays due regard to the requirements of economic stability must surely be a proper production policy. The better the balance that can be achieved in the allocation of resources between rates of growth in consumption and investment, the less will be the burden thrown upon fiscal and monetary policy for the maintenance of economic stability alongside rapid economic development'.[26] Can we have a proper production policy if the State action is merely an emergency action intended to fill in gaps in effective demand? Moreover, an essential pre-requisite of 'balance' is not only that primary increases in expenditure be controlled but that secondary increases be also regulated. When a government has spent a certain amount of money initially on an investment project, a part if not the whole of it must occasion fresh spurts of expenditure. Perhaps some of this expenditure, as for example, that of labour on food is such that we cannot do much about it except either to have more food or to ask others to reduce their food

25. _World Economic Survey_, 1957, p. 110.
26. Op. cit., p. 13.

consumption. But what about that money which Mr. Kaldor says, goes to 'increase the wealth of the richest classes disproportionately?'[27] An expenditure tax[28] can restrict the misuse of this money in conspicuous consumption. But it is doubtful if the money released but still in possession of a rich man would be invested in directions which from a social point of view are not undesirable. For this, the State has to assume the role of a planner for the whole economy rather than a helper of the private entrepreneures.

It is hardly a convincing argument to say that since under-developed countries are not collecting through taxes that percentage of national income which developed economies are collecting and since their rate of taxation of increments at the margin is less than in the latter, there exists a considerable scope for a bolder wielding of the weapons of fiscal policy. This may be all right if the developed and under-developed economies are similarly placed in regard to their national and per capita real incomes. But it is obviously incorrect to make that assumption.

If two persons have the same real income 'X' and their real incomes are also rising at the same rate 'dX', then both can be taxed to the same extent on the average as well as at the margin. But if one person's real income is higher than that of the other; further if 'dX' for the former is greater than it is for the latter, the argument for approximating the average and marginal taxation of the latter to that of the former can hardly be

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27. Nicholas Kaldor, <u>Indian Tax Reform</u>, Ministry of Finance, New Delhi, 1956, p. 1.
28. Ibid.

seriously taken. The right decision will clearly rest upon what the poorer man can bear but this has nothing to do with the comparison of his burden to that of the rich. What is valid between differently placed individuals in the same country should be valid for countries too. That fiscal policy in under-developed countries must be bold cannot be disputed but it does not seem plausible to justify this boldness on the ground of such international comparisons.

What are the limits of the poorer countries' ability to pay? We may if we like insist upon the principle of 'least aggregate sacrifice' and go through the rather imaginary labyrinth of the marginal disutilities of different classes of people and attempt their equalisation. But unless we interpret marginal disutilities in a social rather than individual context, unless 'least aggregate sacrifice' is related to 'maximum social advantage' understood in a wide and dynamic and not a narrow and static sense, fiscal policy in under-developed may not be able to do all that the advocates of boldness desire it to do.

It could be argued that Keynes and modern growth theorists have provided ample scope for a flexible interpretation of the familiar principles of public finance, the limit in the Keynesian case being set by the emergence of a threat to full employment while the limit in the case of growth theorists being set by a rise in the ratio of output going to consumption. But neither Keynes nor modern growth theorists consider these limits except on the assumption of the usual rules of the game -- profit-motive, free competition etc. If the view expressed here that such rules

of the game go ill together with the requirements of development of under-developed countries is correct, we may have to have a much surer basis for what we want than would be provided by a combination of, let us say, the most liberal interpretation of the principle of 'least aggregate sacrifice' on the one hand and the preservation of the old rules of the game on the other.

Whether fiscal policy can completely succeed in forcing the rich to take to investments based more on the considerations of social necessity and less on those of profit remains to be seen. But the fact is there that without a difference in the principles of the private sector's behaviour in regard to the secondary disposal of incomes originating from budget deficits, export surpluses etc., stability in the economic development of under-developed countries may not be easily achieved. It is quite possible for government plans for investment to be themselves erroneous both as regards their character as well as volume. But the solution there is not to avoid planning but to have it in a more determined and thoughtful way. And in any case, that does not free the private sector of its own share of responsibility in promoting the right type of economic development.

The issue of tertiary effects of an initial dose of investment might be ignored because of a desire to let a multiplier - accelerator process work in the economy. But the operation of this process assumes certain conditions for its working. One such condition is that the supply curve of output below full employment is elastic. There is no doubt that in under-developed areas we do not have full employment of labour but the concept

of full employment in the theories of the multiplier and the accelerator is a little different. It implicitly assumes that the full employment of land, labour and capital, more or less, go together which is not a fact so far as under-developed areas are concerned. In these areas full employment of capital co-exists with widespread unemployment of labour. Thus while potentially the supply curve of output can be treated as elastic on the supposition that production is carried on with labour only and no conflict between the fact that the supply curve of output in under-developed economies is rather inelastic and the possibility of its becoming elastic under a well conceived plan of economic development. It is obvious that without expansion of output, there cannot be any growth. But this expansion will not come about by waiting for a multiplier-accelerator process to do the trick. Capital equipment, technical know-how, foreign exchange, raw materials and food -- all are notoriously short in supply and as long as the multiplier-accelerator process works in this background, it can succeed more in redistributing factors of production into different uses and less in adding to their supply, unless it is operating in the direction of creating these factors themselves.

This is an important reason why we should be careful in applying to under-developed countries, Professor Rostow's deduction from history about the role of 'leading sectors'.[29] It may tempt us to suggest that if railway tracks have been laid or some

29. The Take-off into Self-sustained Growth', Economic Journal, March, 1956, p.43

similar leading industry established, the rest of the story will automatically follow. If it followed in countries which are now developed, that might have been because there was no trouble on the score of natural resources, population, food, enterprise etc. The countries with which we are dealing here have not been lucky enough to have such a harmony between the determinants of development. So that in their case, may be, every step has to be planned and co-ordinated for quite a long time to come.

It is here that the argument that inflation promotes capital formation (taking capital to mean just plain physical equipment) through redistribution of income in favour of saving classes loses a part of its force. For as long as the saving class is not investing in basic overheads, it will only redistribute available capital equipment and not really increase its aggregate quantity. In this particular case, it may not really be much use trying to distinguish as Professor Lewis tries to do, between the effect of inflation upon peasants on the one side and upon the private industrialists on the other. Professor Lewis argues that the passion of the peasant will be 'dissipated merely in changes in the price and distribution of land'.[30] Perhaps, yes, but the position of the supply of physical capital equipment in under-developed economies may not itself be very much better than that of land. Why cannot it be possible that the passion of the industrialist also is dissipated in more or less the same manner as that of the peasants?

30. 'Economic Development with Unlimited Supply of Labour', The Manchester School, May 1954, p. 169.

We can consider another and a different case of why, for countries which have not yet crossed the poverty barrier, the character of investment is an important element in capital formation. Any given surplus could be as well invested in, say cosmetics, as in food, and both will be cases of capital formation but is it not better for poor countries that this surplus be invested in food rather than in cosmetics? While putting forward growth theories and approaching the question of capital formation in macro-economic terms, we often give the impression as if the qualitative aspect of capital formation is unimportant. It may be so for economies which have crossed the poverty barrier and for whom the choice might, perhaps, lie between two varieties of cosmetics or between cosmetics and some other similar commodity. But for economies below the poverty barrier investment in 'essentials' is the prime necessity.[31] So that the more is an under-developed economy below this barrier, the more important the task of directing a given surplus into socially desirable directions becomes.

Indeed, there seems to be a positive correlation between poverty on the one side and the need for a planned economic development on the other.

In a nutshell, we can say that,

(a) under-developed areas are those where the various determinants of development (population, enterprise, technical

31. In 1960-61, the United States' per capita income was 37 times as high as India's (India's per capita income that year was Rs 293.70), Japan's seven times as high, Sweden's 29 times as high and Israel's ten times as high. India's per capita income was even lower than that of Thailand, Burma, Ceylon and most other under-developed countries of Asia, Africa and Latin America.

progress, savings, natural resources, food, etc.) have been in a chronic state of disharmony in relation to one another;

(b) their private enterpreneurs suffer from a 'state of suspense' so far as new, long period investments are concerned;

(c) both these facts suggest that economic stagnation of these areas will tend to be perpetuated if they are sought to be developed through what is known as the competitive system of production;

(d) for under-developed areas, economic planning is an inevitable choice; it is inevitable both for economic development itself, as well as for a rapid and certain, economic development;

(e) a planned economy should not be confused with the usual type of a 'mixed' economy. In the latter, the state supplements the competitive system which is basic to the economy's growth; in the former, the planning body is the basic instrument of development, the private entrepreneurs merely serving as a supplement to the planning body;

(f) since that is so, the private entreprenours in a planned economy cannot hope to function according to the same rules of the game which are valid for a 'mixed' economy; their behaviour should largely be determined by reference to what the planning body wants and not only by reference to profit-motive, competition etc.;

(g) the recognition of the need for a change in the rules of the game is specially necessary if the object is to absorb an ever-growing surplus of man-power through labour-saving devices;

(h) if secondary spurts of private expenditure are regulated according to the fiscal and other economic policies derived from 'mixed' economies which believe in different rules of the game, under-developed areas may not succeed in achieving the twin objectives of stability and a rapid economic development.

THEORY OF MONETARY POLICY IN RELATION TO OVER-POPULATED UNDER-DEVELOPED ECONOMIES.

CHAPTER 2

OF

OBJECTIVES MONETARY POLICY

What is monetary policy? Monetary policy is the name given to the principles whereby the Government and the Central Bank of a country fulfil the general objectives of the country's economic policy. Thus interpreted monetary policy has no objectives of its own and is at best a handmade of general economic policy.[1] This is as it should be also since all the various policies that we normally think of viz., fiscal policy, commercial policy, monetary policy, are different aspects of the same single entity which we call by the name economic policy. As is that entity, so are its aspects or change the metaphor, as is the whole, so are the parts.

There was once a time when a Government was not supposed to interfere with the working of a competitive mechanism because competition based on the principle of maximisation of one's profits was supposed to solve all economic problems. There was no particular economic policy and, therefore, no particular monetary policy also. The main task of the Government was to

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1. In the words of the Radcliffe Committee, "monetary measures "are not so much a policy in themselves as a part of one general economic policy which includes amongst its instruments fiscal and monetary measures and direct physical controls."
Report, August 1959, p. 337.

ensure unhindered working of the economic machine which naturally included the monetary machine as well. For example, during the days of the gold standard, all that the Central Bank of the country was to do was to see that currency expansion and contraction took place according to changes in the inflow and outflow of gold in the economy. As for whether price stability would or would not be there, full employment would or would not be there, the Central Bank had nothing to worry since a smooth working of the economic system according to the rules of the laissez-faire and the pure gold standard games would assure the automatic fulfilment of those aims. Today, however, we think differently of a laissez-faire economy and we of course do not have a pure gold standard as we recognize that the objectives which were supposed to be automatically achieved would remain far away from us unless deliberate and purposeful measures either initiated or fostered by the Central Bank of the country are taken and so economic policy becomes a matter of importance in the context of the present day world.

What are the various objectives which economic policy of a country aims at? First of all, there is the objective of maximising economic growth of a country so that its people may continue to produce and consume an ever increasing quantities of material wealth. It is now felt that Government policies can make a difference to the proportion of national income which is invested and if by some suitable manipulation we can increase this proportion, we have naturally increased the rate of growth of a nation's material resources.

Another objective is that of maximising total employment. It was Keynes who successfully pointed out that a competitive economy left to itself would normally be unable to take us to the point of full employment. Even before that level has been reached, automatically generated forces might not only present the economy from being taken to the point of full employment, they might compel it to revert to situations of increasing unemployment. He, therefore, emphasised the necessity for the State to take deliberate measures so that the economy could advance towards the point of full employment. And now-a-days full employment objective is considered to be an imperative of economic policy. The third objective is that of stabilising the internal price level. It is felt that if prices begin to rise at a speed which is very much faster than the one that is desirable in the interest of the economy, all manner of unfortunate reactions will be caused leading even to the possibility that the objectives of growth and maximum employment themselves are not fulfilled. Thus Governments and Central Banks must try to hold the price line as well.

A fourth and rather important objective from the point of view of a country where foreign trade constitutes a considerable proportion of national income is that of maintaining stability of the exchange rates. The thing is that when a country is incurring a continuous and heavy foreign exchange deficit, there are bound to be reactions on internal prices, growth and employment and so economic policy must also aim at maintaining stability in our foreign exchanges.[2]

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2. Reflections on Monetary Policy, Sir Oliver Franks, p. 10.

A last objective of economic policy is a fairer distribution of national wealth between different classes of people. The days when acute inequality was accepted as inevitable are now over. Social and economic thinkers, no matter what their political affiliations accept the desirability of reducing inequality of incomes in a country and a Government in modern times must encourage measures which are intended to bring about a realisation of this objective.

There are two things which come out sharply from the above discussion of objectives in economic policy: (1) the objectives of economic policy are determined by the men who are in power in a country at any given time so that for the economist and the monetary theorist they constitute a sort of a given data. It is open to the Central Bank of a country not so much to question these objectives as to help work them out. (2) These objectives are not easily reconcilable with one another.[3] For example, if we are attempting to maximise growth by way of having more producers' goods and less consumers' goods we may create inflationary conditions and to that extent the objective of maintaining stability of prices becomes difficult to fulfil. Also if we are giving too much emphasis to capital-using biases in production because a capital-intensive technique offers a higher re-investible surplus and, therefore, promotes a higher rate of growth, we would not be creating employment at a rate which is equal to the

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3. As the Radcliffe Committee put it, "The aims of economic policy to which monetary action is related are complex: they can be directly in conflict with each other in the short term and only by adjustment can be held in balance in the long." Report, p. 337.

task of achieving full employment in the economy.

Take the objective of a better distribution of incomes. It is widely held that whereas inequality of incomes means more income to the profit-earners, equality of incomes means more income to the consumers. And from the point of view of growth of the economy, it is better if more income goes to the profit-earner rather than to the consumers since profit-earners will, to that extent, be able to step up the rate of investment and the rate of growth of out-put and employment. Thus it is difficult for a Government to fulfil all these various economic objectives at the same time. Some times, therefore, it may choose to insist on some objectives while at other times, on others. For example, the Government of an under-developed economy might choose to concentrate on the growth objective rather than on the 'employment or the fairer distribution of income objective[4] whereas the Government of a developed economy might choose to

4. India has been trying to achieve all these objectives at the same time. In the language of the Third Five Year Plan, "..... ever since Independence, two main aims have guided India's planned development -- to build up by democratic means a rapidly expanding and technologically progressive economy and a social order based on justice and offering equal opportunity to every citizen". (p. 4). But one doubts if she has been successful in promoting the objectives of a fairer distribution of income and fuller employment. The Mahalanobis Committee has expressed the fear that concentration of economic power in India might have increased since the First Plan. As for fuller employment, the backlog of unemployment (this does not include disguised unemployment or under-employment) at the beginning of the Fourth Plan is expected to be about 3 millions greater than that at the beginning of the Third Plan.

concentrate on maintaining rates of growth of output and employment and stability of external and internal values of money.

A reconciliation between various objectives of economic policy is not impossible. But for such reconciliation, we may have to develop perspectives which are different from those which permeate competitive economies. We have already referred to these perspectives in the previous chapter.

CHAPTER 3

CHEAP MONEY POLICY, ITS ASSUMPTIONS AND RELEVANCE

What monetary policy, we might ask, would be suitable for the objectives which an under-developed country wants to achieve?

Since, following Keynes, the countries of the world (including under-developed countries) have, by and large, been highly enthusiastic about cheap* rather than dear money, it might be worthwhile examining in as much detail, as possible the assumptions on which that policy is supposed to be based, and its relevance to over-populated under-developed economies.

First of all, cheap money policy implies that the economy in question has a highly organised and well-developed money market. It is clear that if there is an economy where the money market is ill-organised[1] and ill-developed, we may not have any considerable demand for idle money balances. In any case, this demand may not be related to financial investments like bonds,

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* In the discussion that follows 'cheap money policy' and 'liberal money policy' have been treated as interchangeable phrases.

1. Some thirty years ago, the unorganised market "financed as much as 90 per cent of the internal trade of India. With the expansion of banking, the percentage has come down but even so it is estimated to be as high as 50 per cent at present". H.V.R. Iengar, Monetary Policy and Economic Growth, 1962, pp. 192, 193.

securities etc., in the same manner in which it may be related to them in developed money markets. With such a weak relationship between idle balances and financial investments, increased quantity of money may not result in a lower rate of interest. Another assumption of cheap money policy is that investments, by and large, are monetised.[2] If the non-monetised investments in an economy constitute a substantial proportion of the total investment, cheap money policy, which obviously will affect monetised investments only, may not make as much difference on the plane of the economy as might be imagined. A third and important assumption of cheap money policy is that marginal efficiency of capital is falling. This means that as investments are being made and the level of employment and income in the economy are rising, the state of expectation and the level of technical knowledge remain unchanged. It is clear that if there is some kind of technical progress taking place, the productivity of new investments would rise and provided there is no change in the state of expectation of the enterpreneurs, the whole marginal efficiency schedule will move up. In such a situation obviously, the inducement to invest would rise because of technical progress itself and there will be no need for an inducement in the shape of a lower rate of interest.

There is another aspect of the matter which might be borne in mind. An economy might be considering investments from the social rather than individual point of view.[3] In such a case,

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2. "Rough estimates for Sample Surveys suggest that between 20 and 25 per cent of all savings and investment was non-monetised in the pre-plan years...." Wilfred Malenbaum in East and West in India's Economic Development, 1959, p. 25.
3. Third Five Year Plan, p. 9.

marginal efficiency of capital would be interpreted in terms of the gain which the investment would bring to the society rather than to individuals. Now-a-days when the State is fast becoming an organ of social welfare, such considerations should be increasingly possible. However, the calculation of the social productivity of investment may force upon us the need to interpret interest as a social rather than private cost and to necessitate manipulation of monetary policy on lines different from those suggested by cheap money policy. To what extent this will happen will depend upon to what extent Governments are allowing their considerations of net investments to be affected by objectives of a socialist society. Yet another assumption of cheap money policy is that the demand for investment is interest-elastic, that is, demand for new investment will rise provided there was some reduction in the rate of interest. Now the importance of rate of interest in the cost structure of enterprises may be so small that this may not happen. The desire to invest may be augmented more by the fact of wage reduction or tax concession and less by bringing down the rate of interest. It might be useful to recall here Keynes's views that booms and slumps in competitive economies were largely determined by fluctuations in the marginal efficiency of capital, which themselves were, by and large, determined by fluctuations in producers psychology.[4] In other

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4. "The Trade Cycle is best regarded, I think, as being occasioned by a cyclical change in the marginal efficiency of capital.....". The General Theory of Employment, Interest and Money, J.M. Keynes, Macmillan & Co. Ltd., 1960, p. 313.

words, the crucial fact was the optimism and pessimism of the entrepreneurs so that as long as they expected that future would bring forth lucrative returns even a higher rate of interest will not matter. On the other hand, once they become pessimistic in regard to the prospects of profit, even a low rate of interest will not help. Keynes himself had suggested that rate of interest always played a second fiddle. That being so, how does it matter whether rate of interest is or is not low?.

One might say that there is a contradiction between cheap money policy and Keynes's suggestion that economic crashes are precipitated by unbridled optimism of the business community. We should not forget here the fact that the prescription of cheap money policy is meant for a situation in which investments have been so considerable that there is a rapid and steep fall in their marginal productivity (an accelerated operation of the law of diminishing returns). Keynes's explanation of such hectic investment activity is that the business community has become extraordinarily optimistic in regard to the future.[5] But if this is so, any lowering of the rate of interest might even make matters worse since given that extraordinary optimism, a lower rate of interest will mean a greater net profit and, therefore, a further spur to that optimism. At a time like this, one might, making all those assumptions which are implied in a cheap money policy, as well suggest a dear money policy. A higher rate of interest might moderate the enthusiasm of the

5. op. cit., p. 321.

entrepreneurs just as a lower rate of interest might increase it.

The point is whether in deciding about how interest should behave, we have to fix upon the physical productivity of investment which is only one element in the marginal efficiency of capital[6] or upon the marginal efficiency of capital itself. If we are looking to the former, we are ignoring state of expectation which is according to Keynes himself the most important of the elements which constitutes the marginal efficiency of capital. If, on the other hand, we look at the whole of marginal efficiency of capital, we have to ignore the declining physical productivity of investment resulting from an accelerated operation of the law of dimnishing returns. The Keynesian explanation of the depression suggests that a boom lasts as long as the entrepreneurs are not fully realising the implications of a fast declining physical productivity of their investments. Soon as that realisation dawns upon them, optimism gives way to pessimism and there is a crash. If at a time of high investment activity, the Central Banking Authority decides to lower the rate of interest and tells the business community that it is doing so because it considers that there is now an accelerated operation of the law of diminishing returns, it may not only not succeed in sustaining the onward march of the economy, it may even precipitate the crash by advertising a fact the ignorance of which alone has been making possible the current prosperity. It seems that from the state of expectation point of view, a dear money policy

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6. op. cit., pp. 135 to 146.

might be more desirable and there is no doubt that in the kind of situations which cheap money policy is supposed to deal with, the state of expectation point of view would be more important than the declining physical return point of view. One begins to suspect if cheap money policy follows as logically from the Keynesian analysis as is usually suggested.

Further the advocacy of cheap money policy rests upon a certain evaluation of the attitude of labour with which many would not agree now. The suggestion is that even if such a policy has raised prices and cost of living of the workers, this would not lead to emergence of the vicious circle of cost - push inflation because below full employment, labourers do not resist a rise in their cost of living and a decline in their real wages.[7]

If we recall Keynes's definition of unemployment, "Men are involuntarily unemployed if in the event of a small rise in the price of wage-goods relatively to the money wage, both the aggregate supply of labour willing to work for the current money wage and aggregate demand for it at that wage would be greater than the existing volume of employment".[8] This suggests that when an economy is at less than full employment level, availability of labour willing to work can be taken for granted even if real wages are lower than before, provided the decline in real wages is small. The suggestion is the outcome of two assumptions:

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7. "Whilst workers will usually resist a reduction of money-wages, it is not their practice to withdraw their labour whenever there is a rise in the price of wage-goods". op. cit., p. 9.
8. op. cit., p. 15.

one, that at full employment wages are equal to marginal productivity as well as marginal sacrifice of labour, and two, that in all situations including those of less than full employment, wages are equal to marginal productivity.[9] It is clear then as the following diagram suggests, that in a less than full employment situation, wages will be higher than marginal sacrifice and the labourers will be earning a certain rent element in their incomes.

When labourers earn a rent element in their incomes, they would not mind a reduction in their real wage. Thus as long as unemployment lasts, labour's willingness to work can be safely assumed. If real wages do not decline or rise above the current

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9. op. cit., p. 5.

level, increased supply of labour will, of course, be available but even when real wages are declining there would be no trouble. Hence, the almost exclusive emphasis in the 'General Theory' to keep the employers happy, since with increased supply of labour assured, increased demand for labour remains the only problem and this could be tackled by increased expenditure on all fronts. How basic the view of a higher supply of labour at lower real wage is to the 'General Theory' can be seen from the prescription of increasing expenditure as a cure for unemployment. Keynes had admitted that increased expenditure before full employment would raise prices. "It is probable", he said, "that the general level of prices will not rise very much as output increases so long as there are available sufficient unemployed resources of every type. But as soon as output has increased sufficiently to reach the 'bottle-necks', there is likely to be a sharp rise in the prices of certain commodities."[10] Now since with rising prices there was every possibility of real wages going down, unless it was supposed that the labourers would put up with lower real wages, the game of cheap money, deficit finance and higher output and employment could not be played any further. And some other devices to achieve full employment might have to be discovered. But one's economic prescriptions or devices go with one's economic theory and may be then the 'General Theory' has to give place to some other which is more in keeping with the facts of our times.

Can we say that ordinarily labour's willingness to work at

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10. op. cit., p. 300.

declining real wages can be taken for granted? Keynes himself was not very certain and so he talked of a small rise in the price of wage goods relatively to the money wage and not of a big rise because a big rise might perhaps lead to such a diminution in the real wages of labour that the aggregate supply of labour would not increase even when the demand for labour in the economy was rising. Now what is a small reduction in the real wage, 1%, 2% or 25%?

Here then we observe a serious limitation of the 'General Theory'. The smallness or the bigness of the diminution is a matter of opinion which is shaped by the economic circumstances in which we live and through time these circumstances have been so changing that even a very small reduction in real wage may be considered as big by the labourers. In Keynes's own country, labour opinions of the sixteis are so very different from those of the thirties.

Then there are some other difficulties also.

For example there is an obvious difference between saying that an employer's equilibrium requires that he pays a wage which is equal to marginal productivity of labour and that in actual fact he does pay that wage. We are aware that in conditions of absolute monopoly in the labour market, an employer may in fact pay wages which are different for different units of labour and just equal to the marginal sacrifice of each of these different units and no more. Perhaps in the real world such a monopoly does not exist but we should not go to the other extreme as well and say that we have perfectly competitive conditions in labour

market and therefore, all labourers shall be paid marginal productivity and no less, otherwise other employers will be able to draw labour from those who refuse to fall in line with the rest. We know fully well that we have no perfect competition amongst the employers of labour. And in any case, how can such a competition prevail as long as we are assuming unemployment in the economy? Thus it may be that in actual fact labourers are getting less than their marginal product and, therefore, the losable rent in their real wage may be much less than imagined.

What about labour's marginal sacrifice? A look at the diagram above will show that marginal sacrifice of labour rises as more labour offers itself for work but along a single curve.

A word about interpreting labour's sacrifice when the disutilities of different kinds of work are given[11] may be desirable. Suppose a labourer is asked to double his work from 8 to 16 hours; it is clear that the marginal sacrifice of the 16th hour's work should be greater than the marginal sacrifice of the 8th hour's work. But what if we engage two labourers working 8 hours each? Shall we able to say that the 8th hour's sacrifice of the second labourer is greater than the 8th hour's sacrifice of the first even on the assumption that the second labourer is identical in all respects with the first? This means that we may not be right in drawing the marginal sacrifice curve in the manner indicated above. But with some other shapes of the marginal sacrifice curve, the losable rent might again be smaller.

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11. op. cit., p. 245.

The possibility that the marginal sacrifice curve, assuming that it has no other shape except that given above, might shift up and so the gap between marginal productivity and marginal sacrifice corresponding to a given level of employment might close further leading to a further fall in the loseable rent, assumes changeability in the disutilities of work done by labour and is not compatible with Keynes's assumption. But why should in that short period, which constitutes the base of the Keynesian analysis in the 'General Theory', the disutilities of different kinds of work remain constant? Here again we have to remember the difference in the time when Keynes was writing and now. In the thirties, perhaps, no difference might have been made ~~to the disutilities of labour's work within a period made~~ to the disutilities of labour's work within a period made up of at least one boom and one depression (that is the minimum length of a Keynesian short period) but in such period, a difference in the present day world is almost inevitable because labour's reaction to work, tied as it is to the fast changing social, political and economic consciousness of our times, is changing fairly rapidly.

On balance, it thus appears that the assumption that in less than full employment conditions, labour's willingness to work despite a declining real wage, can be taken for granted may not be very valid.

In under-developed countries particularly, there may be difficulty in accepting this assumption since wages are so close to the subsistence level that they may not just admit of a

reduction.[12]

The issue of the relationship between liberal money policy and wage rates has been a lively issue in some western economies. But the debate there has centered largely on the demand for labour vis-a-vis its supply. It is contended by the protagonists of a liberal money policy (and they include some trade unions) that such a policy raises the inducement to invest in the economy and by boosting up the demand for labour, leads to fuller and fuller employment. If money wages rise in the process and prices also rise, this must be controlled by whatever means seem plausible including fiscal means but not by reverting to dear money. If we have to choose between rising employment and rising wages and xprices, we should, they say, choose the former. On the other hand, the opponents of a liberal money policy suggest that our choice should be a little bit of unemployment so that we may avoid the vicious circle of rising wages and inflation.

While the relevance of a liberal money policy to rising wage rates should be analysed, it is doubtful if in under-developed countries it consists in any relationship between demand for labour and its supply. Except in case of skilled labour, the supply of labour in such countries is far in excess

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12. "Now, one who is acquainted with the conditions of an under-developed economy, with the earnings of the majority of the working population practically below the minimum subsistence level, will find it hard to see how the prevailing real wage in these economies could be too high". A.K. Das Gupta, Keynesian Economics and Under-developed countries in Keynesian Economics - a Symposium ed. V.B. Singh, 1956, pp. 156-157.

of the demand. Of course, liberal money policy leading to a higher demand for skilled labour and through it to a higher level of wage rates for skilled workers may result in a competitive wage increase so far as the large mass of unskilled labour is concerned. But this is not the same thing as wages rising owing to the direct impact of a rising demand for labour.

What then is the relevance of a liberal money policy to rising wage rates in under-developed economies? If we start with the assumption that an extra dose of investment in these economies will take a certain amount of time to bear fruit and that there is little possibility of the newly employed being fed and clothed out of the current stock of food and clothing, created money would certainly raise prices as soon as extra investment is made. With a given level of money wages, this would mean a reduction in real wages for a great volume of labourers in the economy. This will lead to a fight for increase in money wages.

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In some developed countries, like Great Britain the trade unions are so well organised that they would not allow the real wages to fall even though they might be much above the subsistence level. In under-developed countries, the real wages are not much above the subsistence level itself. Moreover, the demonstration effect of communism and the general advance of political and economic awareness has put in considerable power in the hands of trade unions even though they are not so well organised as their British counter-part. Both these factors make the validity of the Keynesian assumption doubly difficult in the underdeveloped economies. The result is that when prices rise, a fight for protecting the real wage invariably begins. But while it may not succeed

in restoring the cut in real wage because when a larger number of employed workers share a given pool of consumers' goods no amount of jugglery with money wages can undo the damage, it does end up in a rise in money wages and cost of production and therefore, in a vicious circle of cost push inflation.

Thus though the ultimate impact of an easy money policy may be the same in underdeveloped as in developed economies, that is, cost inflation, the reason for which the effect is brought about is different. In the latter, it is the rising demand for labour which pushes up wage rates, in the former it is price inflation which does that. In the former we start with a stable price level which could be kept stable had labour not been in short supply; in the latter we start with inflation and push up wages irrespective of the supply of labour.

The following table will show that the level of real wages of the factory workers in India in 1958 and 1959 was less than what it was in 1952. Only in 1960 and 1961, it could rise above that level. The rise in money wages is considerable as is the rise in the consumer price index.

Consumer Prices, Money and Real Wages of Factory workers in India

Year	All India consumer price Index number (base shifted to 1951 = 100)	Money wages per worker	Real wages per worker
1952	98	107	109
1953	101	108	107
1954	96	108	112
1955	91	113	124
1956	100	115	115
1957	106	121	114
1958	111	119	108
1959	115	122	106
1960	118	130 Provisional	110 Provisional
1961	120	138 Provisional	115 Provisional

Source: Reserve Bank of India Bulletin, April 1964, p. 494.

In respect of other categories of labour, particularly labour engaged in housing construction, the fact of rising prices leading to reduced real wages and then to a clamour for higher money wages is even more common. In factories the situation is better partly because the workers are less unskilled and can, therefore, press for wage increases not necessarily related to prices and partly because of Government keeping a strict eye on wage contracts. The best evidence of rising money wages following inflation is that of workers in the Government offices. Indeed anywhere where dearness allowance is related to prices, it will be inflation which will precede rising wages and not the other way round.

CHAPTER 4

MONETARY THEORY* AND MONETARY POLICY

Why should prices rise when a liberal money policy is in operation? Should they rise because increased money supply leads to increased investment which in turn leads, via diminishing returns, to higher average and marginal costs of production or because additional money supply is reflected in excess demand for goods of various kinds? Since the question is fundamental and has a bearing upon monetary theory, we might recall the position in regard to the relationship between increased quantity of money and the price level which was taken up in the "General Theory". The "General Theory" had suggested that all impacts of changes in the quantity of money would be transmitted through the liquidity preference function particularly through the behaviour of the speculative motive. Once, supply of money increased over its current level, excess money would find its way to the bond market and lower the bond rate unless the liquidity preference of the people had in the mean-

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* Keynesian monetary theory is an integral part of his General Theory. Since many of the General Theory's assumptions are not valid in respect of under-developed countries (we have examined some in the previous chapter; many others we would examine in the pages that follow), an analysis in terms of the alternative approaches of Mr. Don Patinkin and the Chicago School led by Professor Milton Friedman has been attempted. The ideas elaborated here are basically theirs, but the presentation of these idea's has been done in a different language. A small attempt has also been made to integrate these ideas in the interpretation of the demand function for money.

while become absolute.[1] Provided the bond rate and along with it the other rates of interest declined, investment could increase and affect prices, according to the possibilities of returns at the margin of that investment. Keynes did not feel that some, if not all, excess money would be unloaded straightway into commodities' rather than the bond market and thus excess money supply could raise prices via excess demand for goods in addition to whatever happened via increased investment and diminishing returns.

In view of the great relevance of this issue to underdeveloped economies, we might devote a little time to the statement of arguments which try to rehabilitate the basic quantity theory relationship between money supply and prices vis-a-vis the more popular Keynesian approach.

Suppose a person has chosen to divide his resources between goods and money in such a manner that he has to start with G units of the former and M units of the latter. From the law of proportional marginal utility, we know that when a person has chosen to hold X amount of rice and Y amount of wheat, the marginal utility of X divided by that of Y should be equal to the ratio of prices of these two commodities. So that if the marginal utility of X rice is 20 and that of Y wheat is 10, the price of rice should be twice the price of wheat.

If now something happens whereby our consumer's stock of rice increases beyond X, marginal utility of X would decline and the ratio of the marginal utilities of rice and wheat would no longer remain 2 : 1 which it formerly was. Since the ratio of prices is 2 : 1 already, some substitution of rice for wheat will

have to be done so that a new equilibrium may be established. This too is very likely, that the prices of rice and wheat change as a result of this substitution. That is, the ratio may be something else rather than 2 : 1. The important thing, however, is that if a new equilibrium has to be established, the consumer cannot insist upon maintaining the entire addition of his stock of rice. So that if this stock becomes double of what it was before, that is, 2X, part of the extra 1X of rice, the consumer will have to give away in order to acquire more wheat. And in this process the price of wheat in terms of rice must rise. With his insistence to retain the entire of the additional stock of rice and refusal to substitute more rice for wheat, the price of wheat in terms of rice may remain unchanged but the consumer shall not be in equilibrium.

As with a consumer's stock of rice and wheat, so with any individual's stock of goods and money. Let us suppose that an individual has decided to hold his resources in two forms, namely, goods and money. Let the amount of resources which he holds in the form of goods be G; and that which he holds in the form of Money be M. Let the marginal utilities of both M and G be 20. Then the ratio of the marginal utilities of M and G would be 1 : 1. If this individual is to be in equilibrium, the ratio of the prices of M and G should also be the same.

We might say a word here about marginal utility of M and the ratio of the prices of M and G.[2] We know that money has a utility only because we feel we can convert it into goods and

2. Money, Interest and Prices: Don Patinkin, 1956, p. 62 ff.

and services. If the amount of goods and services which M can buy for us is larger, that is, if M represents a larger real money balance, marginal utility of a larger amount of goods and services being smaller, marginal utility of M would also be smaller. Since money is not wanted for its own sake, marginal utility from it would depend upon the amount of goods and services which the consumer can buy with it. These goods and services are different from G which he has already bought. Theoretically speaking whereas M represents G_1 which an individual can buy with M as and when he likes, G is what he already has. In a way G_1 are goods and services of the immediate or the distant future whereas G represents goods and services of the past and the present. The ratio of the prices of G_1 and G can, for simplicity of analysis, be assumed to be 1. The price of G is the same thing as the average price of the goods and services which our individual is buying at present. It can be taken to be the present price level of commodities. The price of G_1 may be taken to be the price level likely to prevail in the immediate or the distant future. We know that there can be a great difference between the two price levels. However, since for our argument the precise difference between the two price levels is not material, we suppose that the price level of G_1 and that of G is the same. In that case, the ratio of the two prices would be equal to 1 and this is also the ratio of the marginal utilities of M and G. We have already assumed the marginal utilities of both to be equal to 20 and their ratio to be equal to 1.

Now suppose that the stock of money increases from M to 2M. The immediate consequence of it is that the individual's real

balance becomes double. But if G_1 has become $2G_1$, the marginal utility of G_1 cannot remain the same. It should come down to a lower level. Let us suppose that it has been reduced to 10. The ratio of marginal utilities of G_1 and G now would be 10 : 20 or 1 : 2 and this is different from the ratio of prices. The individual cannot insist upon retaining the entire addition to his stock of money; if he does, the marginal utility of his real balance divided by the marginal utility of goods he already has would be different from the ratio of prices and he would be in a state of disequilibrium. The interest of the individual's equilibrium demands that he tries to get rid of some of the extra real balance which has been created by an increase in the stock of money. Since we have supposed that the individual holds his resources either in the form of G_1 or in that of G, when he tries to get rid of G_1, he should try to substitute G in its place. But substitution of G_1 for G is the same as substitution of money for goods since real balances are held in the form of money. And when goods are acquired in exchange for what an individual considers extra money, the prices of goods may rise.

Now we might transfer the analysis from the individual to the economy. When an individual unloads his extra real balance for goods, the supply of goods to him may increase at the time his demand for them is also increasing. However, the supply of goods to the economy is a different matter. The total supply of goods in the economy may remain the same when holders of extra real balance are attempting to substitute money for goods. At any rate, there is no reason why soon as they have started unloading

extra real balance, that supply should increase. Later when a fair amount of time has elapsed, certain factors may come into play and influence the supply of goods. But immediately when quantity of money has increased, and real balance has become excessive and people have begun to unload extra real balance, there is no reason why the aggregate amount of G available to the economy should not remain constant. Clearly, if that is the position, the efforts at substituting money for G would not result in the economy as a whole holding more G than before but in just raising its price. The faster the rate at which substitution is effected, the higher will be the increase in the price of G.

We remember that we started with M having become 2M, and, therefore, the real balance represented by the stock of money also having become double. However, in the process of unloading extra real balance (because ratio of marginal utilities of real balance and goods would have got out of tune with the ratio of prices) the price of G would have risen. On our assumption that there is no difference between the price of G and G_1, the price of G_1 would also have risen. With the rise in the latter, the power of M to buy G_1 will be reduced so that now 2M will represent less than $2G_1$ real balance. In fact, the greater is the rise in the price of G_1, the lower will be the amount of G_1 which 2M would represent. To start with, doubling of M had left these prices uneffected and therefore 2M represented $2G_1$ real balance but now the position is changing. We have already seen that substitution need not be accompanied by any change in the aggregate supply of G to the economy; it may result not in the

economy holding more G than before but in raising the price of G. In so far as the amount of G available to the economy remains the same, marginal utility of G remains 20. As for the real balance represented by the new stock of money, it tends to diminish with the rise in prices resulting from substitution. Suppose that at some stage the prices of G and G_1 have become double, what will be the amount of real balance with the economy then? If the money balance of the economy has become 2M and the price of G_1 has also become double, 2M will represent real balance equal to G_1. That is to say, the real balance of the economy would have got reduced by the economy's attempt to substitute money for goods and reverted to its original level G_1. Once the real balance has become G_1 again, its marginal utility will become 20 and the ratio of the marginal utilities of G_1 and G would be equal to 1. Since the prices of G_1 and G, by assumption, are rising to an equal extent, the ratio of prices would remain the same and equilibrium would have been re-established. As long as substitution has not resulted in doubling the price of G and G_1, 2M will represent real balance greater than G_1. As long as that is so, marginal utility of real balance would be less than 20. As long as that is so, the ratio marginal utilities of the real balance and goods would be different from the ratio of prices and there will be no equilibrium. Holders of real balances would feel that they have more than they require for their equilibrium; they will try to substitute extra real balance for goods; prices of G and G_1 would rise till they feel that they have no extra real balance at all. But this cannot be unless prices have risen in the same proportion as

quantity of money.

This is one of the possibilities of what Don Patinkin calls the real balance effect.[3] The real balance effect is merely the impact that is exercised upon an individual's or an economy's holding of money and goods when real balance increases beyond what it should be in the interest of equilibrium. As has been pointed out, increase in the stock of money available to the people must, in the first instance, mean an increase in their real balance. This increase in real balance, assuming that there is equilibrium to start with, upsets equilibrium and necessitates substitution of money for goods. This substitution leads to certain results, e.g., raising of prices or increase in the amount of G held by the people or both. It is these results that constitute the real balance effect. Don Patinkin's point appears to be that if we consider the real balance effect of increased quantity of money, it is inevitable that prices of commodities rise directly rather than the way Keynes had suggested in the General Theory. In Keynes's analysis, increased quantity of money must first be directed towards buying bonds and lowering the rate of interest. If prices rise, that will be because lower rate of interest would have led to higher investment, higher investment to greater output, greater output to higher marginal and average costs of production and that to higher prices. There is no direct impact of increased quantity of money upon prices in the Keynesian analysis. The real balance effect suggests that such an impact is also there.

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3. op. cit., p. 21.

This is a different matter that as a consequence of this direct impact of increased quantity of money upon prices, prices may not rise in the same proportion in which the quantity of money has risen. But by some margin or the other, they must necessarily rise. In the example which we took above, we had said that people held their resources in the form of money or real balance G_1 and goods, G. Suppose we define G in such a manner as to include in it bonds and other wealth tokens as well. That is, G, we might say now stands for goods as well as bonds. When excess real balance necessitates substitution of money for G, this would not only mean substitution of money for goods but also substitution of money for bonds. The prices of both would now be higher than before. However, in so far as the prices of bonds would be higher, the bond rate of interest would be reduced. This means that the acceptance of the real balance effect does not contradict Keynes's view that increased quantity of money should result in lowering the bond rate. Only that whereas Keynes had suggested that excess money would be substituted only for bonds and other wealth tokens, the real balance effect suggests that it will be substituted for goods as well, so that commodity prices would rise <u>at the same time</u> as the bond rate of interest is falling.[4] In Keynesain analysis, they rise <u>as a consequence of</u> the fall in the bond rate.

The fall in the bond rate would encourage investment, raise output and increase the supply of G to the economy. We have seen above that provided the supply of G was fixed, the

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4. op. cit., pp. 256 to 269.

real balance effect would work itself out in raising prices of G and G_1 in the same proportion in which the quantity of money has risen. But we if it works itself out in lowering the rate of interest as well, the supply of G must increase. What will be the precise rise in prices in such a situation would depend upon the degree of the rise in the supply of G. In under-developed countries, this would depend upon how quick yielding is the investment which has been prompted by a lower interest inducement. The greater the gestation period of investments, the greater will be the rise in the prices of commodities. In any case the real balance effect would lead to some raising of the price level independently of what might happen as a consequence of a fall in the bond rate.

We have suggested in the analysis above that people would not hold any extra real balance generated by the increased quantity of money because that upsets their equilibrium. We can also argue that they would not hold extra real balance because that increases the cost of holding that real balance. It has just been pointed out that in their attempt to restore equilibrium, holders of money balances raise prices of commodities. This rise naturally engenders fears in the minds of the holders of the money balances that prices would continue to rise in the future as well. This will be particularly so if the increase in the quantity of money has been very considerable. If we look to the history of inflation in different countries of the world, we would, it has been suggested, find that periods of excessive expansion in the quantity of money were periods of severe

inflation.[5] It is natural for holders of money balances to recall that history now when they are faced with a situation of a very considerable increase in money supply. Thus, partly for the reason that prices are in fact rising via the real balance effect and partly because there has been a positive correlation between increased quantity of money and prices in the past, holders of money balances fear that prices would continue to rise in the future. This means that the real balance represented by the present stock of money, that is, G_1 would continue to fall. Naturally then, it becomes costly to hold real balances in the form of money.[6] The higher the level of prices expected to rule in the future, the greater is the depreciation in the idle money held and the more rapid the rate at which real balances represented by a given stock of money would decline. And the more rapid that rate, the more costly it becomes to hold real balances in the form of money rather than in some other form.

We remember that idle money is held for transactions as well as for speculation. So far as transactions are concerned, there is a certain amount of goods and services which people must buy. Some money has to be held for making purchases of

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5. "..... there is, perhaps, no other empirical relation in economics that has been observed to recur so uniformly under so wide a variety of circumstances as the relation between substantial changes over short periods in the stock of money and in prices.....". Milton Friedman, <u>Studies in the Quantity Theory of Money</u>, 1956, pp. 20, 21.
6. The Monetary Dynamics of Hyper inflation: Phillip Cagan, in <u>Studies in the Quantity Theory of Money</u>, ed. Milton Friedman, 1956, pp. 31, 33.

commodities. If they do not hold money, they would not be able to pay for their purchases. This may either involve their not buying those commodities at all or buying them on credit. People can buy commodities on credit too. And in so far as that is possible, they may not hold idle money balance in a situation where the cost of holding those balances is expected to rise. But there is very little room for manoeuvring here. So that we can legitimately assume that real balances held for satisfying the transactions motive would continue to be held even when the cost of holding them is increasing. The same, however, cannot be said for their real balances held for speculation. The fact that a certain amount of money is kept idle rather than invested in bonds shows that people hope to be net gainers by that decision. If bonds were held, interest will, of course, be earned but capital loss might be incurred too. The two put together, i.e., interest gain and capital loss do not seem to be less disadvantageous than holding idle money. Keynes did not consider the fact that holding money idle does not merely represent a loss of interest, it also involves a carrying cost equal to the rate at which money is depreciating in value. When this <u>entire</u> amount of loss involved in holding money in the form of idle real balance is compared with the possible gain in holding the real balances in the form of commodities rather than money, it might be more worthwhile to hold commodities. After all, while commodities may not yield any interest, they should yield a "capital" gain almost in the same measure in which the value of money is expected to depreciate. A depreciation in value of money is the same thing as an appreciation in the price of

commodities. In fact, when prices of commodities are expected to rise, prices of bonds also may. To that extent, even the fear of a capital loss from bonds is neutralised. We may not build a whole calculus of alternatives leading to a precise conclusion here. But we can suggest that in view of so many factors being there, such as the possibility of a capital gain from commodities, that of a reduced capital loss from bonds, holders of idle money balances may be reluctant to retain additional money which is being generated. The cost of holding real balance in terms of the alternative of capital gain from commodities foregone is likely to be greater than the cost which holders of money balances might suffer by abstaining from investing in bonds. The more the quantity of money increases, the more this cost is likely to be a deterrent in the way of their desire to absorb these increases in the form of idle balances for speculation. When we think of the real content of these balances; that is, of the real money balances available to the people in such a situation, beyond a limit, they would refuse to hold these balances. And as they do so, prices of commodities would rise.

It then appears that the proportion which idle balances for speculation bear to an economy's income also tends to remain almost as stable[7] as the proportion which idle balances for transactions bear to income. If money supply increases over and above what people require for transaction and speculation in real terms, excess money is likely to be spent on purchase of

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7. op. cit., p. 16.

commodities and prices would rise. We remember that in the Cambridge equation the proportion of real income over which people want purchasing power in transactions motive is K. Let us suppose that this proportion is K_1 in the speculative motive.[8] This is the same thing as saying that for transactions people want real balance to the tune of KT whereas for speculation (we ignore the precautionary motive for simplicity of analysis) they want real balance to the tune of K_1T. If P is the average price of T, the total money balance which the people demand is P× $(KT + K_1T)$. If an attempt is made to raise the money supply above this level, people will have more real balance than they want for transaction as well as for speculation put together. They would attempt to unload extra real balance and in the process raise the level of r till it has become high enough to make the value of $P\ (KT + K_1T)$ equal to the increased M.

We might recall that in the 'General Theory', Keynes had attempted to argue that provided the bond rate of interest had become very low and there was universal fear that bond prices would fall, every addition to the quantity of money would be absorbed in idle balances for speculation since on account of the fear of capital loss people would not buy bonds any further.[9] If that happens, increased money supply should make no difference to the price level. It is against this suggestion which implies

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8. Normally this proportion is expressed as the fraction of total assets or to use Marshall's word, 'property', which people desire to keep in the form of money balances. If we have used it in the sense of the ratio which such money balances bear to income, it is only to explain the particular point which is being dealt with here.
9. op. cit., p. 172.

that in certain situations any increase in money supply could be attempted without unfavourable impact upon prices that what has been said above becomes significant. No matter what the situation, when quantity of money increases, it puts more real balance in the hands of the people than they want. This, in the first place, upsets their equilibrium with resources not held in the form of money balances. Attempts are naturally made to correct this equilibrium by acquiring things which are not money. Also, when the amount of real balance with the people increases, partly on account of the rise in prices resulting from their attempt to restore equilibrium and partly on account of their past experiences of a positive correlation between increased money supply and prices, the cost of holding extra real balance increases too. Why should this increasing cost be incurred when the alternative of holding commodities which are appreciating in value in the same measure in which money is depreciating is more profitable? Thus both because people want to re-establish equilibrium which increased money supply has upset and also because the cost of holding real balance is greater than that of not holding it, extra real balance is likely to be unloaded into the commodity's market and raise prices.

The crucial questions here are firstly whether whenever people have a certain demand for money, they prefer to think in terms of the real value of that money or the nominal value? In other words, is money demanded because people are aiming at having command over goods and commodities no matter whether that command is going to be implemented immediately as in the transactions motive or later as in the speculative motive or

it is demanded for its own sake? A second question, equally crucial is whether at any given time the proportion of their real income over which people want a command in terms of money does or does not remain stable over time. We have seen above that there is a certain proportion of their income over which people want command for the immediate future. This is the real balance satisfying the transactions motive and even the Keynesians would agree that this might remain more or less stable over time. But there is a certain proportion of their income over which people want command in terms of money for a more distant future. This is real balance satisfying the speculative motive. The issue is whether this proportion also tends to remain more or less stable over time. If it is, then we could accept the view that holders of money balances at any given time are interested in real balances which are such a proportion of their real income (this proportion will be worked out by combining K' and K_1) as tends to remain more or less stable over time. Provided real income is constant, there is a definite amount of real balance which the people want to hold or over which people want command in terms of money; that is, there is a definite real balance over which people want a hold in the form of money balances. The amount of money balances corresponding to this real balance could be worked out by multiplying that real balance by the average price of commodities. If the monetary authorities insist upon creating more money, people will hold more real balance than they want at the given prices. This extra real balance must find its way into the commodities' market and raise prices till the increased money balance has been

reduced to the level of the real balance which people desired to hold. Can we say that the real balance which people desire to hold for speculation is a more or less stable proportion of their real income? Is it not possible that if people are forced to hold more real balance than they want for speculation they will not agree to hold it? Keynes's point in the 'General Theory' was that they would, whereas the arguments presented here indicate that they would not, the first set of arguments emphasising the disequilibrium aspects of holding extra real balance and the second set emphasising the cost aspect of holding of extra real balance.

As to whether when people are getting more and more money, they would think of retaining or not retaining it in an idle form after reducing it to real terms, the answer depends very much upon whether they do or do not suffer from money illusion. It has been suggested that an important assumption of the 'General Theory' is that people suffer from such an illusion.[10] This becomes clear from Keynes's view that labourers would not mind it if money wages are kept the same but prices of wage goods are increased. They would, however, mind if money wages were reduced and prices were kept the same. Thus in their first reaction labourers, Keynes suggested, prefer to think in money rather than in real terms. While in certain situations it could be possible for holders of money balances not to bother about working out their choices in real terms, as for example when the price level has remained stable and is expected to

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10. <u>Money, Interest and Prices</u>: Don Patinkin, 1956, p. 192.

be so, in other situations such as those of rising prices, they might prefer to base their decision on real rather than nominal units of money. In such situations they would be considered as not suffering from any money illusion at all. In the present day world therefore where inflation is an almost every day experience in so many under-developed economies, it might be better to suppose that people do not suffer from money illusion.

Had it not been so, payment of wages in kind in India would not have increased as substantially as it did between the years 1950-51 and 1956-57.

Mode of Wage Payment : All-India

(Percentage of Man-days)

1950-51			1956-57		
Cash	Kind	Cash and kind	Cash	Kind	Cash and kind
1	2	3	4	5	6
56.0	31.3	8.8	48.7	40.5	10.8

Source: Agricultural Labour in India: Report on the Second Enquiry 1956-57, Volume 1 - All-India, p. 423.

In fact, absence of money illusion may have something to do with the slow rate of monetisation of the Indian economy as well.[11] For though factors like movement of labour from agriculture to industry, production of cash crops, urbanisation,[12] and development of credit and banking institutions are important in determining the pace of monetisation, people's fascination for

11. Monetization of an Economy: Santi Kumar Ghosh, 1964, p. 48.
12. op. cit., pp. 35, 42.

money would be even more important. If we look at the following figures we will find that considering the enormous amount of monetary expenditure incurred in the Indian economy between 1953-54 and 1958-59 the monetisation of consumption expenditure in the rural areas has not been rapid.

Value of Home-Produce Consumed as Per Cent of Consumer Expenditure in Rural Areas

Monthly household expenditure groups (Rs)	1953-54	1958-59
1 - 50	49	46
51 - 100	48	43
101 - 150	45	42
151 - 300	44	41
310 and above	36	33
All Households	44	41

Quoted in 'Monetization of an Economy': Santi Kumar Ghosh, 1964, p. 49.

As has already been mentioned, the fact of whether people think of their demand for money in terms of its nominal units or its real value would have much to do with how value of money has been behaving over time. It was, perhaps, legitimate of Keynes not to have bothered about this factor, since the thirties (when the 'General Theory' was written) were a period of such behaviour of prices as could be helpful in the growth of a money illusion. In fact a whole big stretch of period preceding the 'General Theory' was a period of that kind.

Wholesale Prices in the United States

(1926 = 100)

Period	Prices
1830 - 1839	75
1840 - 1849	65
1850 - 1859	65
1860 - 1869	94
1870 - 1879	76
1880 - 1889	60
1890 - 1899	51
1900 - 1909	61
1910 - 1919	88
1920 - 1929	104
1930 - 1939	77

Source: Monetary Theory and Fiscal Policy, A.H. Hansen, 1949, p. 143.

In the words of Professor Hansen, "For the United States, wholesale prices (1926 = 100) stood at 102 in 1800 and at 103 in 1943. In the intervening 150 years*, the average for any one year never fell below 47, and never rose, even in war years, above 155."[13]

What about the position in under-developed countries today? If we take India's case, the prices of goods of middle class consumption (in under-developed countries, liquidity preference - for - speculation idea would be most relevant to the middle classes), shot up more than four times within a brief span of about 20 years since 1939. The cost of living index relating to food and clothing stood at 525 and 569 respectively in May 1960 as compared to 100 in 1939.[14]

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* From 1800 to 1947.

13. Monetary Theory and Fiscal Policy: A.H. Hansen, 1949, p. 143.
14. Inflation in a Developing Economy: The Indian Merchant's Chamber Economic Research and Training Foundation, 1961, p. 112.

How can one afford to have a money illusion in such circumstances?

Therefore, whatever might have been the validity of Keynes's statement that 'The history of India at all times has provided an example of a country impoverished by a preference for liquidity amounting to so strong a passion that even an enormous and chronic influx of the precious metals has been insufficient to bring down the rate of interest to a level which was compatible with the growth of real wealth',[15] at the time it was made. One doubts if that statement would be valid in the country's present circumstances.

The fact that now men, particularly in under-developed countries do not suffer from money illusion is, of course, a point which goes in favour of the post Keynesian interpretations of the quantity theory but the really crucial question is the stability in the proportion of their income which people want to hold in the form of real balances satisfying the speculative motive. The best evaluation of this suggestion would perhaps be statistical. But it may not be naturally wrong to suggest that if quantity of money is increased beyond a certain point, it is bound to get spilt over the commodities market and raise prices. It is difficult to believe that provided people are disinclined to buy bonds for fear of a capital loss, they would agree to retain all the additional money which is being created as a speculative balance. Whether this point represents an upper limit of the real balances held for speculation, real balances varying

15. <u>The General Theory of Employment, Interest and Money</u>: J.M. Keynes, 1960, p. 337.

within a certain range, or it represents a certain value of real balances for speculation which do not fluctuate may not be easy to confirm.

In under-developed countries, however, where like all agrarian economies there is a strong attachment to goods rather than money and where people do not by and large have a speculative motive, because they are too poor to take the risk or where speculation is more in commodities than in financial assets, the real balances held for speculation may be taken to be even more stable a proportion of income than in developed economies.

According to Professor Milton Friedman, "In India, the amount of currency that is held by the people amounts to roughly 7 weeks' income....... the people of Yugoslavia hold in the form of currency something like 6½ weeks' income, remarkably close to the figure for India. Greece is a royalist country with a king and queen and a very different economic structure from that of either Yugoslavia or India. Yet its people hold in the form of currency almost the same amount as in Yugoslavia, a little over 6 weeks' income. In the United States, they hold about 4½ weeks' income in the form of currency. In Israel they hold about 4½ weeks' income also, although the level of income in Israel is ⅕ or ⅙ of that in the United States". "Here we have", he remarks, "countries with every variety of economic system with real incomes varying over a range of 15 or 20 to 1 and yet currency holdings, expressed in terms of weeks' income, vary over a range of decidedly less than 2 to 1".[16]

16. Inflation Causes and Consequences, The Council for Economic Education, Bombay, p. 11.

Professor Friedman argues the case for a positive correlation between money supply and prices with example from India thus. In the First Five Year Plan period, "currency in public circulation - the kind of stuff people carry round in their pockets - rose by 13%; currency + demand deposits rose by 11%; currency + demand deposits + time deposits rose by 15%. The stock of money as defined in any of these ways rose decidedly less than the 18% increase in output. In consequence, prices fell. In the Second Five Year Plan period, the stock of money rose more than output. Again if we take each of the above definitions of money, currency alone rose by 25%; currency + demand deposits by 33%; currency + demand deposits + time deposits by 53%. The stock of money rose more than output; hence prices rose".[17]

Stability in the proportion of real income held in the form of money can be upset but not in a way as to neutralise the excess demand which is generated by an excess expansion in money supply. Citing the Indian case again, Professor Friedman observes that in the First Five Year Plan period, money supply as defined by the Reserve Bank namely currency + demand deposits rose by 11%, real output rose by 18% and the difference is 7%. This is the amount of decline in prices that would have occurred if people had continued to hold the same amount of money expressed in terms of their income throughout the period. However, "when prices are going down, money becomes a more desirable way in which to hold assets......... Hence people have a strong tendency if they expect price decline to continue to hold a larger fraction of their wealth in the form of money. On the other side of the

17. op. cit., pp. 2, 3.

picture when prices are going up, money becomes a less desirable form in which to hold assets. In consequence, people tend to economise on their money balances; velocity tends to increase".[18]

Thus the proportion of their real income which people desire to hold in the form of money balances is not necessarily a rigid or a fixed one, but the change in this proportion whenever it occurs is unlikely to help in the absorption of excess money balances and this is what Keynes was trying to suggest in his liquidity preference theory. The bond rate mechanism might help that absorption but only so long as we are not bothering about the real content of the money balances. Very often excess money synchronises with rising prices which threaten to reduce the real content of one's money balances, no matter for what purpose they are held, in the present as well as in the future. In face of such a situation, there is every likelihood that people would tend to keep their money balances to whatever minimum is possible. In their effort to get rid of excess money balances, ~~it is unavoidable that they increase their balances~~, it is unavoidable that they increase their demand for goods of various kinds and prices rise independently of cost of production.

While there is ample evidence in India to establish that variations in the quantity of money and prices are somewhat positively cor-related even independently of whatever happens to returns at the margin of investments, there is no firm and adequate evidence to suggest the inverse relationship between variations in the quantity of money and the rate of interest

18. Ibid.

which was the purport of the monetary theory of the "General Theory".

Professor Khusro's study[19] of such relationship in India suffers from limitations of which he is himself fully aware. For example he agrees that "it is the practical statistical difficulty of making an estimation of the value of real property that forces us into excluding this form of wealth".[20] And so a very important alternative under the "speculative motive" is left out. His derivation of idle balances on the basis of an assumed income velocity and his choice of a period which did not permit of as wide a range of assets as would normally be available (a good part of the period of his study, 1937-1952 was taken up by war and post-partition emergencies) are further limitations. However, even with these limitations, he could not work out a relationship between quantity of money and the long period rate of interest about which he could feel enthusiastic. For he says that while "we may ..... conclude by looking at the coefficient of correlation that a substantial part of the movement in the rate of interest was accounted for by the change in the ratio of idle balances to the total liquid assets of the private sector of the Indian economy in the years 1937-1952. ..... We may also say that during these years the responsiveness of the rate of interest to changes in the liquidity ratio was very small, a percentage change of 1 in the liquidity ratio being accompanied on the average by a negative percentage change of only 0.062 in the long term rate of interest".[21]

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19. Liquidity Preference in India, Indian Economic Review, Feb., 1957, pp. 24 to 40.
20. op. cit., p. 36.
21. op. cit., p. 40.

Thus putting the theoretical and the emperical considerations together, it appears that in under-developed countries particularly, the demand function for money need not be related exclusively to the rate of interest or other returns from wealth assets satisfying the speculative motive. Speculation is a luxury not as frequently open to the poor as to the rich. It involves one in risks which one can take provided one enjoys a high level of income. The poverty of under-developed economies is too well known to be mentioned. From the point of view of vast masses of people in such economies, money is demanded for speculative motive and therefore the demand function for money should be more related to prices of commodities and less to the returns from speculative wealth.

Even the wealth market in under-developed economies is not well developed[22] so that wealth is demanded more as a permanent asset and less as one which is easily saleable at short notice. The speculative element behind asset accumulation, assuming that people are rich enough to indulge in the luxury, is much weaker than what we might find in developed, competitive economies. Thus even where there is a demand for money satisfying speculative motive, it may not be analysed in just the same way as the speculative demand for money has been analysed in the 'General Theory'.

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22. "Whereas the paid-up capital of joint stock companies - the main basis of the bond market in the private sector - is almost half that of the national income in U.K., in India it is only 7%. Secondly though in recent years, public debt securities have grown very much in importance their ratio to national income in India is ¼, whereas in U.K. it is twice that of the national income", J.D. Sethi, _Problems of Monetary Policy in an Underdeveloped Economy_, p. 30.

In respect of under-developed economies such as India, the total demand for money is thus partly a function of prices of commodities and only partly, if at all, a function of the rate of interest and other returns from speculative assets.

Now direct overflow of money balances into the commodities markets in under-developed economies opens up a possibility of speculation which can even make for a positive and not a negative cor-relation between increased quantity of money and the rate of interest.[23]

Ordinarily when holders of money balances allow this balance a spill over into the commodities market and money depreciates in value, commodities would be correspondingly expected to appreciate in value and so commodities may be more worthwhile for storing for purpose of speculation. In future, at higher prices they should bring higher profits. But if this tendency develops, the demand for commodities would rise far more than it would have risen in the absence of speculative motive. The result will be that prices of commodities would rise by even a bigger margin. With a greater rise in prices, the expected appreciation in prices of commodities might also be greater; the desire to speculate in commodities might be further accentuated. And so on in a vicious circle.

In under-developed countries, speculation in commodities is more common than in bonds and equities. This is because the bond market is neither broad nor active, most people even not knowing what it is and where it is. In vast geographical areas, one does not find more than a few stock markets. On the other hand, the

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23. op. cit., p. 43.

market for commodities is much more expansive.

A factor making for commodity speculation in under-developed countries is the nature of finance to which the rank and file of the business community can have access. As we know, finance could be given for trade as well as for manufacture. However, in under-developed countries finance tends to be given more for trade than for manufacture. Even some of the foreign banks prefer to lend to exporters and importers rather than to those who are engaged in the production for exports. In the rural areas, non-institutional finance, like the loans of the Mahajans or the Sahukars also tend to be given more for trade and less for production. When finance is widely available for trade, it is natural that there is a growth of speculative activity in commodities.

The practice of speculation in commodities in under-developed countries may also be ascribed to the fact that commodity prices in those countries are liable to frequent changes. This is because the economies of these countries are predominantly agricultural in character and agricultural production, which depends so much on nature, experiences more ups and downs than industrial production. With frequent variations in agricultural output, it is inevitable that there should be frequent variations in the prices of the agricultural commodities as well. Even on the external plane the same thing would happen. Agricultural exports from under-developed countries experience frequent price changes because of the fluctuating nature of the industrial countries' demand for under-developed countries' agricultural exports.

Now if commodities are preferred to bonds as an alternative in speculation, increase in quantity of money may not work out

its way to a low rate of interest in the manner suggested by the monetary theory of the 'General Theory'. Speculation could raise commodity prices so much that speculators might like to borrow more money to buy stocks of commodities. This rush for increased demand for credit might occasion a rise in the rate of interest. Thus not only may the rate of interest not decline when the quantity of money has increased, it may actually go up because people are trying to satisfy their <u>speculative motive</u>. In any case there is no reason to deny that the demand function for money may be such that a part of increased quantity of money exercised an impact upon prices which is independent of the impact emanating from increased investments and increased marginal and average costs of production. If excess money is absorbed only through adjustments in the rate of interest and in the volume of real investments, one may not fear the consequences of cheap money policy since prices would at best rise to the extent of the rise in average and marginal costs of production. But if that adjustment takes place even partly through demand induced rise in prices, cheap money policy would almost unavoidably lead to the emergence of inflationary conditions. The thing is that Keynes's demand function for money does not recognise at all the possibility of increased money supply leading to a demand induced inflation. On the other hand, the old fashioned quantity theory did not recognise that increased money supply could affect prices through larger output and the concomitant higher marginal costs resulting from a lower rate of interest and higher investment. The truth, so far as, at least, under-developed countries with their relatively inelastic supply curve of output are

concerned, lies somewhere in between the two extremes. But if that is so cheap money policy has to be viewed with considerable alarm.

CHAPTER 5

CAPITAL DEFICIENCY OF [illegible] AND MONETARY POLICY

An assumption of cheap money policy is that the economy has unutilised stock of capital. If that were not to be so, increase in net investment consequent upon a reduction in the rate of interest may not lead to an increase in the volume of employment. With capital stock in short supply, any attempt to raise net investment in the economy would bid up prices of the given capital stock but not lead to an increase in employment and income. It is very well known that in the Keynsian system, real income must rise in order to raise effective demand to a position where it may be in consonance with the increase in net investment. We know that there are many countries in the world where capital stock is scarce and where, therefore, the trick will not be done by increased utilisation of whatever capital stock is available. In such countries, the problem is to raise stock of capital itself. Whatever merit cheap money policy may have in inducing a rise in real income via a greater use of otherwise idling capital stock, it is not clear how it can be helpful in raising the volume of capital stock itself.

Some might suggest that if finance were to be cheaply available and the volume of monetary investment could rise in the capital goods sector, this will, after a time-lag lead to the production of more capital equipment and therefore to an

enlargement of the stock of capital in the economy. But how can additional capital equipment flow out of this sector unless with the help of the finance made available to the investors, they **first** get the real capital which is ultimately going to produce this equipment and how can a prior availability of this, Capital be supposed if we have assumed that all the existing capital stock is being fully utilised? We often miss the elementary point that finance only enables us to mobilise whatever is idle in the economy and cannot be a substitute for it. Mere creation of finance, therefore, is not the same thing as addition to the capital stock.

Closely related to the assumption of the available idle capital stock is the assumption that the supply curve of out-put is elastic. What is meant by an elastic supply curve of out-put? The suggestion implies that an economy can go on having higher and higher real income on the basis of a given volume of resources. If the volume of resources is R then by merely agreeing to apply more and more finance to R by way of engaging more labour, using more raw materials, and producing more capital equipment, we can produce more and more out-put. So long as this can happen, we will say the supply curve of output is elastic. If on the other hand, application of more finance to R does not lead to any increase in output, we will say that the supply curve of output is inelastic. For in this case unless R changes to R_1 (such that R_1 is greater than R) more out-put shall not be forthcoming. Thus when supply of out-put increases as a result of increase in the total volume of resources itself, the supply curve of output will not be elastic even though output is.

It is of course true that even where R is most fully employed, increase in output as a result of mere application of finance can be obtained. For, ordinarily there are no rigid points of full employment, only a range so that within this range limited manoeuvrings can be attempted, the degree of these manoeuvrings depending upon the bigness or the smallness of the range of full employment output. There is no harm in supposing, therefore, the existence in every economy of slight idle capacity so far as the utilisation of R is concerned. But this idle capacity is so slight and indefinable that it cannot be made the basis of any economic policy.

Now to the extent to which stock of capital is a part of R, idling capital equipment will mean a partly idling R and, therefore, an elastic supply curve of output. But it is not from the theoretical point of view essential that this will be so if capital equipment is idle but raw material supplies or labour are being fully used. It may be that there is a certain possibility of capital being substituted for labour but once that substitution limit is reached, expansion of output will stop even though capital stock is still idle. All that is intended here is that while stock of capital is an important determinant of the elasticity of output, it is not the only determinant. One extremely important assumption of cheap money policy often missed in our discussion is that as long as we have assured full employment of capital, full employment of labour is automatically assured and so, what we have to bother about is idle capital and not idle labour. There is no doubt that in certain economies this

assumption is true because in those economies idle capital capacity has been rising faster than population. In such economies, therefore, the creation of a condition in which capital is increasingly used and capital-labour ratio rises requires that the rate of interest is kept as low as possible. But what of the economies where population has been rising faster than capital stock? In such economies, the object cannot be so much to utilise more capital per labourer but the opposite. This is the same thing as saying that as long as we are not in a position to add to our capital stock at the rate at which additions to labour supply are taking place, prevention of unemployment will require not that more capital be used but that more labour be used in relation to the given stock of capital. This obviously reverses the whole picture.

The question of capital intensity of investments in over-populated under-developed economies is very controversial and no firm decision has been reached about it. But these two facts which have been mentioned above, namely, that there is no immediate prospect of a very considerable rise in their capital stock and that their population and labour supply will continue to rise for sometime at a considerable rate, have to be recognised. In so far as most of additional population settles in the agricultural sector, agriculture becomes labour intensive even for the agricultural sector. There is a limit to flexibility in the technical coefficients of production; beyond that limit, absorption of labour in the agricultural sector results in labour making no contribution or negligible contribution to the total output. That is why some economists have suggested that marginal

productivity of labour in the agricultural sector might be zero.[1] It may be difficult on strictly theoretical grounds to supprt this suggestion but it is equally difficult to contradict the intuitive feeling that much of labour can be removed from the agricultural sector without amaking any material difference to total agricultural production.

Some economists have suggested that agricultural labour surplus conceals a certain saving[2] also because after all unproductive labourers still manage to get something to eat at the cost of productive labourers. This means that the productive labourers are consuming less and thereby releasing a surplus to unproductive labourers. If now this unproductive labour could be employed without requiring any substantial capital equipment, we would not need any more saving on the part of the economy and yet get a positive contribution from them to the economy's total output. But employment of such labour without requiring any material addition to the stock of capital equipment implies the adoption of techniques of production where too much use of capital is discouraged. How can cheap money policy help us in this task since the avowed object of this policy is to encourage and not to discourage use of capital.

Where capital is as scarce as it is in under-developed countries, monetary policy should, if it can, encourage techniques of production which economise on capital. And provided

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1. Problems of Capital Formation in Under-developed Countries: Ragnar Nurkse, 1957, p. 33.
2. op. cit., p. 37.

capital shortage is coupled with severe population explosion, the need to discourage capital intensive techniques of production becomes doubly urgent. One can legitimately fear that cheap money policy would encourage rather than discourage such techniques.

But is it desirable that capital intensive techniques be discouraged?

The question is a very fixed one but we would devote some time trying to find whatever answer we can since it may have a very important bearing upon monetary policy in economies with a large surplus population.

The relevant considerations in this issue seem to be the following:

One, for the amount of resources, the economy is sparing at the moment, it must have the largest addition to the national product.

Two, from this addition itself, it should have the largest fraction available for re-investment.

Three, as we aim at this, we do not ignore the fact that there is a surplus in labour supply which threatens to increase with the passage of time.

While each consideration by itself seems easy to satisfy, the task of reconciling all the three is certainly difficult. For example we can say that the first and third considerations favour labour-using devices, but we may not be able to say that the second one also does the same.

Even the first consideration, as we shall presently see, will not lead to as unequivocal a conclusion as that.

Let us take up the maximum re-investible surplus criterion. We first assume here that private capitalists are not inhibited by a state of suspense, that they are prepared to play according to changed rules of the game and that therefore, if we can manage to provide them with maximum profits on capital, the profits will surely be reinvested in socially desirable directions. .

The following table[3] shows that by making different assumptions about the level of interest and wages, we can reach different conclusions about the rate of profit.

Comparative Advantages of Different Methods of Production: A Hypothetical Example

Characteristics	Method of Production			
	A	B	C	D
Total output (units)	10,000	10,000	10,000	10,000
Value Added (£)	10,000	10,000	10,000	10,000
Amount of fixed capital employed (£)	2,000	5,000	10,000	20,000
Number of workers employed	200	100	50	10
Annual output per £ of capital (units)	5	2	1	0.5
Annual output per worker (units)	50	100	200	1,000
Fixed capital per worker (£)	10	50	200	2,000
Durability of capital (Years)	5	10	15	20

Case 1 : Annual Wage £ 45
Rate of interest 8 per cent

	A	B	C	D
	£	£	£	£
Wage bill	9,000	4,500	2,250	450
Capital cost (interest plus depreciation)	560	900	1,467	2,600
Total cost	9,560	5,400	3,717	3,050
Profit: Total	440	4,600	6,283	6,950
As a percentage of fixed capital	22	92	63	35

3. The International Labour Review, August, 1958, p. 126.

Case 2 : Annual wages: A £ 45, B £ 90, C £ 135, D £ 180
Rate of interest 8 per cent

	£	£	£	£
Wage bill	9,000	9,000	6,750	1,800
Capital cost (interest plus depreciation)	560	900	1,467	2,600
Total cost	9,560	9,900	8,217	4,400
Profit: Total	440	100	1,783	5,600
As a percentage of fixed capital	22	2	18	28

Case 3 : Annual wages as in case 2
Rate of interest 16 per cent

	£	£	£	£
Wage bill	9,000	9,000	6,700	1,800
Capital cost (interest plus depreciation)	720	1,300	2,267	4,200
Total cost	9,720	10,300	8,967	6,000
Profit: Total	280	-300	1,033	4,000
As a percentage of fixed capital	14	-6	10	20

That being so, it follows that no technique can be considered as yielding a higher profit than others except because interest, wages and the price of output happen to be what they are in the calculation. Any generalisation on this basis will require proving that the money values involved will, relatively to each other, remain the same in the future. Can we do that? As long as we cannot, it will be better to proceed on facts rather than on deduction.

It has been rightly pointed out that rather than take money values into our calculations, we should consider 'intrinsic' values. As Professor Tinbergen observes "A better insight into the real consequences for the economy as a whole of certain

investments will be gained if, instead of market prices, accounting prices are applied, implying, inter alia, that labour costs are assumed to be considerably lower than market wages indicate. This may lead to the execution of projects not attractive to the private investor; but attractive according to accounting prices".[4] This conclusion will be reinforced if we remember that the accounting rate of interest in under-developed countries could easily be higher than the market rate.

On one assumption, however, a categorical decision does not seem impossible. Suppose we utilise agricultural labour without paying any wages. As to whether that is sensible or not, we can say that they are already consuming something at the moment and shall do so even if they remain unemployed. For it is easy to see that if labour is utilised with wages bill as zero and interest-bill the same per unit of capital, surplus on capital will be higher in a labour-using technique than in a capital-using one.

It can be argued that if labour is offered just the same consumption, as it is currently enjoying, we may not be able to induce it into jobs we have in mind. That might specially be so if we are thinking of utilising labour in occupations where a shift from its current venue of work is involved. For example, a person engaged in cultivation, and not really of much use there, may decline to go to shoe-making unless he is offered some <u>additional</u> emolument. But he may demand nothing if his labour is utilised in his own farm for constructing wells etc. As things

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4. The design of Development, 1958, p. 77.

are at the moment, this is a valid argument. But suppose that rural life has been radically reorganised, and villages cultivate land on a communal or a co-operative basis, can it not be possible then that excess labour of the village is devoted to weaving, shoe-making etc., without an insistence upon compensation for a mere change of work?

Even if additional wages have to be paid, the case for labour-using techniques on surplus criterion may not be finished. It is conceivable that because the labourers have no other opportunities, just a slight marginal increase in consumption is enough to persuade them to work. As is clear, the lower the level of wage, this marginal increase involves, the higher the surplus on labour-intensive techniques becomes.

Let us for argument's sake assume that the capital intensive techniques offer a larger profit on capital than the labour-intensive techniques; is there any certainty that the private capitalist will re-invest the entire of it in socially desirable directions? If the view that capitalists in under-developed countries are inhibited by a state of suspense in regard to long period investments is correct, there is a greater chance of its either going to conspicuous consumption like luxurious buildings or to investments like inventories, speculation, foreign assets etc. Those immediately benefiting from investments should remember the importance of the new rules of the game in a planned economy. We cannot argue out a case for either capital intensive techniques or labour intensive ones on the basis of a higher re-investment surplus without making sure that the entire of it will in fact be re-invested.

Further, there are two questions to be answered here. One refers to the availability of capital; the other to the time up to which surplus will continue to be re-invested at the cost of full employment.

Even if mechanised techniques offer a higher re-investible surplus, what are we going to do if capital equipment does not become available while plenty of labour perishes for want of use?

Part, if not the whole of the answer lies in the case or the difficulty with which foreign exchange resources can be obtained. May be that mechanised techniques attract foreign enterprise, but may be also that when they do not do so, we look abroad for other forms of assistance - loans, grants, etc. The former as well as the latter involve politics and therefore an element of arbitrariness in the decision.

There might, however, be less arbitrariness if we assess the degree to which foreign exchange can be earned through a reduction in imports and an expansion in exports. But as a recent study[5] has warned "It would be unwise to count upon any improvement in the terms of trade of non-industrial countries to raise their ability to purchase imports". About exports, the study observes that they "are very sensitive to internal policies of industrial countries but they may well develop less quickly than the rest of the world trade".

After determining if only arbitrarily the amount of capital equipment that is available, we may still be left with a vast amount of unused manpower.

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5. Trends in International Trade - a report by a panel of experts, Geneva, 1958, p. 6.

Can we utilise it by offering it some ordinary tools and implements and a negligible wage?

This once again brings us to the task of re-organisation of rural life mentioned above.

The question as to whether re-investment of surplus will go on ad infinitum is very important indeed. When are we proposing to stop to ponder over unemployment which, with mechanised techniques, may drag on for indefinite periods of time? As the study in the International Labour Review points out "under capital-intensive and labour-intensive methods, even if employment rises rapidly, the absolute volume of industrial employment created may for a long time remain small in comparison with the amount of surplus in existence".[6]

It can be argued that the criterion of employment is less important than the criterion of the rate of growth of output and that capital-intensive techniques should be treated by reference to the latter rather than the former. This too involves value judgement and an element of arbitrariness.

But let us examine mechanised techniques on the rate of growth criterion.

In all probability a given amount of capital when used in more mechanised production will produce output after a bigger time lag than when used in a less mechanised one; also, in the former case, it will yield a smaller investment of total output than in the latter.

But provided the re-investible surplus in the capital-intensive technique is greater and is re-invested for certain,

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6. op. cit., p. 124.

the rate of growth of output emanating from this technique will gradually catch up till it has first become equal to and then higher than the rate of growth emanating from the labour-intensive technique.

The point N in the diagram represents what we may call "neutral" time. If economic planning is done with an eye on this time, it hardly matters which technique of production is chosen. If, however, the time considered is more than ON, a capital-using technique is evidently better because within that time it leads to a higher rate of growth than the labour-using technique does. Consideration of time smaller than ON, on the other hand, recommends a labour-using technique.

It looks, then, that decision on the basis of the rate of growth criterion cannot be taken independently of the time in

which we are interested.

It is quite likely for governments not merely to decide upon a time within which growth must be achieved but also upon a definite rate of growth. However, this is not a question of choice of techniques so much as of whether the economy concerned can save enough for the given rate of growth to be achieved within the given time.

Let us suppose that we want a particular rate of growth equal ~~to OK_1~~ within the time ON_1. Let us further suppose that to reach that rate of growth with labour-using devices we require savings equal to S_1%; while to reach the same rate of growth with capital-using devices we require savings equal to S_2%, S_2% being higher than S_1% (increase in savings will shift the growth-time curves upwards in the diagram). Whether one technique will be chosen or another will depend upon the economy's saving capacity and not upon the superiority of the rate of growth which is already given.

In short, (i) if the rate of saving and the time in which a community wants to have a higher output are given, a decision about techniques of production by reference to a higher or lower rate of growth can be taken. On the other hand, (ii) if the rate of growth and the time within which it is to be achieved are given, the technique to be adopted can be determined by reference to the amount of saving a community spares for the purpose. (iii) Lastly, if the rate of saving and the rate of growth desired are given, we can work out the time and the technique which are consistent with them. It is doubtful if we can reconcile a given rate of saving with the fact of both the time and

the rate of growth being also given. The only way to do it is to speed up technical progress, raise the output per man and thus push either of the curves in the above diagram to the required level. But there, the question of a choice between two techniques seems hardly relevant.

When governments prefer the second possibility - namely determining time and the rate of growth in advance and then setting about mobilising the requisite amount of saving, the question of the choice of techniques appears already settled by implication. Still it is conceivable that having decided upon a certain rate of saving, a government discovers that it is less than commensurate with the desired rate of growth within a given time, fails to induce technical progress and passes on to more labour-using techniques as a matter of expediency. This too can raise the rate of growth immediately but not to the level desired, unless labour, in the meanwhile, has decided to work more efficiently than before. For such efficiency can cause an upward-shift in the L curve almost in the same manner as technical progress in labour-musing techniques will do. Provided increased labour efficiency and technical innovations combine in labour-using devices, the given rate of growth becomes still more possible of achievement. In fact in such a situation, N shifts further to the right and the duration of "neutral" time is extended. The more this combination of increased labour efficiency and technical innovations occurs in labour-using defices, the longer is the duration of the "neutral" time and the less becomes the justification for the capital-intensive devices. On the other hand, technical progress in capital-using techniques

will shorten "neutral" time and provide a greater justification for that technique. The more we can assume that in under-developed economies the scope for technical progress is limited in capital-intensive techniques of production as compared to the labour-intensive ones, the more justification we may find for labour-using devices.

Fundamentally however, the decision on the rate of growth criterion will depend upon how far ahead in time we would like to look in the matter of economic development.

We should recognise that, economically, the case for planned economic development in under-developed areas rests partly on the ground that the circumstances for development based upon the principles of profit-motive, free competition, etc., require a certain harmony in the determinants of development which these areas do not possess; and partly on the ground that even if such harmony were made to exist, entrepreneurs would not easily commit themselves to long period investments. The explanation of why that should be so lies in their inability to build a clear state of expectation. As to why that should be so, the answer would be that people are inclined to blame the old economic order for their poverty and in the process create an atmosphere uncongenial to the growth of the private capitalist sector. The causal factor is the people's poverty and there is no reason to suppose that their grudging attitude will disappear by the mere introduction of a planned economic development. If people continue to grudge their poverty, there can be intangible costs affecting the re-investible surplus (from the capital using investments) in the shape of inefficiency, trade union activities etc. We may not be

able to maximise surplus for too long upon the shoulders of a grudging majority of people.

There is no harm in trying to work out here the rate at which the present generation discounts future benefits to itself or to posterity.[7] But the concept of time-preference becomes much less useful when applied to societies,[8] more particularly to such heterogenous societies as under-developed areas are. There are greater inequalities of income there than in developed economies.

Further, a given time-preference can always be either changed by persuasion or imposed upon the people. The degree to which one or the other possibility exists is a political issue. Even a government given to democratic ideals may not proceed on the basis of the time-preference which is already there. Such a time-preference, related as it is bound to be in the ultimate analysis to the distance between current poverty and the poverty barrier (equal to a minimum standard of living) might be very high. And governments may feel obliged to compromise on democracy.

This compromise again involves an element of arbitrariness.

One more consideration attaches to the rate of growth criterion. As has been shown in the diagram above, mechanised techniques may begin to bear fruit after the point, T. Meanwhile, additional employment will require its consumption needs to be met and if we cannot redistribute existing aggregate consumption in such a way that some people agree to a reduction in their

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7. Choice of Techniques: A.K. Sen, 1960, p. 82.
8. An Essay on Economic Growth and Planning, M. Dobb, 1960, p. 16.

current consumption equal to what the newly employed must have, we may end up by generating inflationary pressure. The actual behaviour of prices will depend upon the volume of additional employment, the amount of consumption goods released through taxes and voluntary saving and the duration of the time-lag.

For governments which deliberately pursue a policy of inflation, this may not be an important consideration. Even for some others, it may not be important if they believe that after all prices will rise only for the duration of the time-lag; when projects have begun to bear fruit, the rise in prices will be arrested and prices might even be brought back to their original level. But neither those governments which prefer a pressure upon prices as a matter of policy, nor those which would tolerate it as a temporary expedient would like that prices should cause any distortions in a defined pattern of development. The attitude of the governments in this matter may be either to assume more powers to control distortions directly or to shorten the time-lag. But whether one attitude will be taken or another, is once again, a matter of politics and therefore arbitrary.

Summarising we can say that :

(i) the problem of the choice of techniques is not so exclusive as to rule out a compromise; the range of goods with respect to which a real choice arises may be more limited than we imagine;

(ii) if we construct a complete economic calculus by including factors like population, external economies, foreign exchange etc., we do not avoid the element of arbitrariness in our conclusion;

(iii) in deciding this controversy, we have often tended to proceed on the basis of the techniques already known; if researches are carried on, it may be possible to arrive at techniques which economise capital, utilise labour and do not affect the re-investible surplus;

(iv) assuming absence of research, more facts, both in regard to market as well as intrinsic values, need to be worked out as regards interest, wage, price of output etc., to determine surplus.

(v) if we can radically re-organise rural life and induce labour to work on negligible wage, the case for labour-using devices on the surplus criterion is much less equivocal;

(vi) even if the more mechanised techniques yield a higher re-investible surplus, they do not offer an immediately higher rate of growth. This is because (a) they supply output after a bigger time-lag than the less mechanised ones and (b) the increment of output from a given volume of capital in the former technique may be less than in the latter;

(vii) if more mechanised techniques do not create a higher re-investible surplus, the case for labour-using devices becomes less equivocally established on the rate of growth criterion as well; if they do, the latter's case will depend upon whether the planners prefer to look beyond "neutral" time. Provided they have chosen to look so far ahead, more mechanised techniques will be favoured;

(viii) but the time for which planners can look ahead will be arbitrarily determined, depending upon their own assessment of the society's time-preference and the extent to which the govern-

ment is prepared to compromise on democracy.

However, assuming certain biases which are inevitable for a decision here, we can favour labour-using devices because they satisfy both the growth and the employment criteria; capital-using devices seem to satisfy, if at all, the growth criteria only. In addition, the former may satisfy the requirement of stability of prices without which according to many people economic development of under-developed countries can run into very serious difficulties.

Capital output ratios in the Indian Economy 1949-50 and 1960-61.

(at 1960-61 prices)

Sector	1949-50			1960-61		
	RTW* (Rs Croes)	Net output (Rs Crores)	Capital output ratio	RTW* (Rs Crores	Net output (RsCrores)	Capital output ratio
1	2	3	4	5	6	7
1. Agriculture	6057	5093	1.19	9065	6900	1.31
2. Minning	147	87	1.69	183	160	1.14
3. Large scale enterprises	2109	679	3.11	5177	1320	3.92
4. Small enterprises	955	1014	0.94	1200	1120	1.04
5. Railways	1970	214	9.21	2746	360	7.63
6. Communication	116	30	3.86	198	60	3.30
7. Trade & Transport	3518	1301	2.70	5577	1920	2.90
8. Services	5750	1416	4.06	8018	2370	3.38
Overall	20622	9834	2.10	32164	14210	2.26

* Reproducible Tangible wealth.

Source: Changes in the Capital structure of the Economy Over the Two Plan Periods; Uma Datta, paper submitted to the Second Conference on Research in National Income, p. 9.

The above estimates indicate a rise in the capital output ratio of the Indian economy between 1949-50 and 1960-61. Part of this rise can be explained in terms of the relative increase in the prices of capital goods vis-a-vis those of the total domestic product but the fact remains that over the decade, agriculture, large enterprises, small enterprises and trade and transport sectors did experience an increase in the capital output ratio.

As suggested above, this would not have mattered but for the fact that the Indian economy has been facing severe population explosion all these years.

The backlog of unemployment which stood at about eight million at the beginning of the Third Plan is expected to rise to 12.6 million at the commencement of the Fourth Plan.[9] Even during the Fifth Plan the situation is not expected to improve as much as it should.

It is true that the advantage of a high interest rate in the matter of inducing capital-saving bias in production can be easily countered by the disadvantage of a low level of wages as perhaps is the implication of the re-investible surplus examples quoted above. But if low interest rates synchronise with a high level of wages, the argument for abandoning cheap money policy becomes still more unassailable.

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9. Northern India Patrika quoting a Planning Commission Spokesman, July 26, 1964.

CHAPTER 6

MONEY SUPPLY OR LIQUIDITY

The suggestion that under-developed countries may follow dear rather than cheap money policy should remain unaffected by the Radcliffe Committee's view that the lever to operate is not the supply of money but the general liquidity of an economy. To quote from the Report of the Committee, "the factor which monetary policy should seek to influence or control is something that reaches beyond what is known as the 'supply of money'. It is nothing less than the state of liquidity of the whole economy. The behaviour of our economy - in particular, the moderation or pressure of demand from time to time - is influenced by the relative liquidity of potential spenders at any one time, and thus, at one remove, by the liquidity of those who might act as lenders to them or subscribers to their funds."[1]

Even the liquidity lever is not more easily operated if there is the tendency towards excessive expansion in money supply. What the Committee intended to suggest was that in case we desired to make money dearer than before, we would not succeed in our objective if only interest rates chargeable by commercial banking institutions, were raised. We should regulate the entire interest rate structure of the economy including that part of it which is related to non-banking financial institutions.[2] Commer-

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1. Report of the Committee On the Working of the Monetary System, August, 1959, p. 337.
2. Ibid.

cial banks, after all, are not the only source of credit in modern economies. And as long as other sources are there, reduced money supply through action on commercial banks can be neutralised by the availability of credit through other financial institutions. We need to act upon total supply of credit to the economy rather than upon quantity of money.

Trade Credit in the Company Sector in India.

(In Crores of Rupees)

Year	Public Limited companies		Private Limited companies	
	Bank credit	Trade credit	Bank credit	Trade credit
1955	143	253	28	54
1956	212	299	31	65
1957	259	341	34	72
1958	270	361	33	75
1959	266	387	38	78
1960	325	420	48	86

Quoted in the Reserve Bank of India Bulletin, November 1963, p. 1404.

Now, as already mentioned, liberal money policy tends to increase the general liquidity of the economy and makes monetary control even more difficult. If it is unavoidable to follow such a policy, the increased difficulty of controlling the liquidity structure has to be faced. But if such policy is adhered to even where it is not necessary (and according to our arguments it is neither necessary nor desirable in some under-developed countries) the central banking authority would obviously be creating an avoidable problem.

Financial Deficit in the Public Sector and the Growth of Liquidity in India : 1951-52 to 1960-61.

(Rs Crores)

Years	Net increase in Money Supply with the Public	Financial Deficit of the Public Sector	Net Increase in the Liabilities of the Public Sector
1951-52	-179.4	40.1	65.4
1952-53	- 43.8	87.4	57.2
1953-54	25.1	114.9	108.8
1954-55	132.6	272.7	324.3
1955-56	264.3	279.6	359.7
1956-57	128.8	407.3	486.8
1957-58	77.1	695.9	733.4
1958-59	110.0	661.2	718.2
1959-60	204.9	515.1	744.9
1960-61	201.5	587.5	748.6

Sources: (i) Financing of Capital Formation in the Public Sector in India: 1951-52 to 1960-61, Paper by K.C. Sharma, submitted to the Second Conference on Research in National Income, pp. 24, 25. (ii) Reserve Bank of India Bulletin, July 1961, pp. 1058, 1059.

The above figures show that money supply with the public in India rose by Rs 264.3 crores during the First Plan; during the Second, it rose by Rs 722.4 crores. The total financial deficit of the public sector was of the order of Rs 795 crores during the First Plan but it rose to Rs 2767 crores during the Second Plan. The total net increase in the liabilities of the public sector works out to Rs 915 crores for the First Plan but over the Second Plan it rose to the level of Rs 3371 crores (excluding the Reserve Bank's holding of special treasury bills). Out of this, the net

increase in liabilities to the non-banking domestic sectors (these include house-holds, enterprises, local authorities, financial institutions other than banks and residual) amounted to Rs 626 crores during the First Plan and to Rs 1154 crores during the Second Plan.[3] The total support by the banking system (as measured by net acquisition of holdings of Government securities + increase in one rupee notes + ways and means advances by the Reserve Bank + commercial bank credit to Government enterprises + variations in cash balances) works out to Rs 313 crores during the First Plan period and to Rs 1162 crores during the Second Plan period.[4]

The thing is that the over all liquidity of the Indian economy has been rising because capital formation in both the public and the private sectors is based on attitudes of a liberal rather than dear money. Of the total increase in the liabilities of the public sector, the Reserve Bank of India accounted for 19.0% during the First Plan and 33% during the Second Plan, and commercial banks for 4% and 0.6% (excluding support by P.L. 480 deposits) respectively during the two five year periods.[5]

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3. Financing of Capital Formation In the Public Sector in India: 1951-52 to 1960-61.

   Paper submitted by K.C. Sharma to the Second Conference on Research in National Income, p. 28.
4. Ibid.
5. Ibid.

National Income and Liquidity in India 1949-62

(Amounts in Crores of Rupees)

Year ended March	National income at Current Prices	Quasi Money (excl. P.L. 480 funds)* Outstandings	% of 2 to 1	Postal Survey instruments outstandings**	% of 4 to 1
1	2	3	4	5	6
1949	8,650	389	4.5	25	.03
1950	9,010	405	4.5	41	.05
1951	9,530	441	4.6	63	.07
1952	9,970	474	4.8	94	.09
1953	9.820	519	5.3	120	.12
1954	10,480	558	5.3	147	.14
1955	9,610	613	6.4	179	.19
1956	9,980	714	7.2	211	.21
1957	11,310	763	6.7	242	.21
1958	11,390	840	7.4	294	.26
1959	12,600	1,004	8.0	353	.28
1960	12,950	1,214	9.5	409	.32
1961	14,160	1,477	10.4	467	.33
1962	14,630	1,579	10.8	515	.35

* Savings and time deposits with banks (excluding P.L. 480 funds) and Postal saving deposits; figures for time deposits are annual averages.

** Excluding Annuity Certificates, Cumulative Time Deposits and Postal saving deposits.

Source: Reserve Bank of India Bulleting, November, 1963, p. 1405.

As for the financial intermediaries in the Indian economy, there are quite a few but in many cases they are either a creation of the Central banking authority and the Government or at any rate not so much out of their control that the increased liquidity due to them can render monetary control as difficult

as might appear on the face of it.

Credit to Private Sector by Various Financial Institutions in India.

(Rs Crores)

	1956	1959	% of col.2 to total	Variation (Col. 2 over col. 1)
	1	2	3	4.
1. All Commercial Banks	239	1099	57.6	+260
2. Credit Cooperatives	141	254	13.3	+113
(i) Agricultural	80	164	8.6	+ 84
(ii) Non-agricultural	61	90	4.7	+ 29
3. Indigenous banks	--	250	13.1	--
4. Specialised industrial finance institutions	19	53	2.8	+ 34
5. Life Insurance Corporation	123	154	8.1	+ 31
6. Private Indian General insurers	10	18	0.9	+ 8
7. Investment companies and Trusts	--	80	4.2	--
8. Total		1908	100.0	

Source: 'The significance of Non-Bank Financial Intermediaries to Monetary Policy in India': J. Narayanan, The Journal of the Indian Institute of Bankers, January, 1961, p. 26.

We can see that the share of the commercial banks in the total outstanding institutional credit to the private sector in 1959 was as high as about 58%. However, in so far as the non-bank institutions were providing 42% of the total, they would also be quite important.

Amongst the non-bank financial institutions, the investment companies and trusts would be of minor importance. The indigenous bankers would be important in so far as the credit supplied by

them accounted for 13% of the total institutional credit in 1959. The Life Insurance Corporation accounted for 8% of the total and the increase in its credit to the private sector between 1956 and 1959 was less than ½ of the increase in commercial bank credit over the same period. The share of cooperative credit was 13 to 14% of the total credit outstanding in 1959 while increase in co-operative credit between 1956 and 1959 was about 45% of the rise in commercial bank credit during the same period.

However, two of the three non-bank sources which are important need not cause much complication for monetary policy in India because they can be easily controlled and regulated. The cooperatives are largely fed by the Reserve Bank. Their borrowings (including purchases of shares and debentures) from the Reserve Bank and Government together amounted to Rs 92 crores or 36% of the total credit in 1959. The reliance of the cooperatives on official finance between 1956-59 rose by Rs 61 crores or by 54% of the increase in credit during this period.[6] As for the Life Insurance Corporation, it is a Government owned institution. Thus, except for the liquidity of the indigenous banker, the liquidity of the non-bank financial intermediaries as indicated by the growth of the supply of credit to the private sector is not as uncontrollable as might appear at first sight. And in so far as such intermediaries are fed by the Central Bank itself, the liberal money policy followed might have much to do with the growth of that liquidity.

The indigenous bankers often base their supplies of credit on their own resources. A liberal money policy provided it raises

6. Non-Bank Financial Intermediaries, G. Narayanan, The Journal of the Indian Institute of Bankers, January, 1961, p. 27.

agricultural prices because agricultural output tends to be more sluggish than industrial output, would tend to drain off real income into the agricultural sector. This should, in the peculiar set up of that sector, where the poor farmers are partly if not entirely within the clutches of the village money lender held the indigenous bankers to boost up their resources and increase their liquidity.

Low interest rates help increase the liquidity of indigenous bankers for another reason. Since the interest rates in the unorganised sector of under-developed economies are very high when compared to those in the organised sector, indigenous bankers are able to command even greater resources in the form of rural savings. And this naturally increases their power to lend.[7]

Increased liquidity is, often, the consequence of a rise in prices of the assets held by different financial institutions. This is what the Radcliffe Committee called the 'general liquidity effect'.[8] But, is it not a liberal rather than a dear money policy which in under-developed countries helps in raising prices of financial assets?

It appears then that both because much of the rising liquidity in under-developed economies is a Government or a Central Bank creation and can be more easily tackled and also because it is helped by liberal money policy, the case for a stricter control on money creation remains.

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7. Interest Rate Policy by F.D.M., The Economic Weekly, November 14, 1958, p. 1529.
8. Some Reflection on Monetary Policy, Sir Oliver Franks, p. 31.

It is difficult to find justification for a policy of deficit financing except on the ground that a larger supply of output, whether it is freshly produced or released from fresh monetisation of the economy, needs extra money to lift it from the market. But will not the job for providing extra finance be better done by the banking system? If a government feels that it should do the job itself it must freeze commercial bank advances at the pre-deficit-financing level. Few governments in under-developed areas might like to go as far as that for fear of annoying the banking system. The banks will dislike being res-trained at a time when increased liquidity following increased government borrowing makes it attractive for them to expand their advances.

The suspicion is that it is something other than the anxiety to keep the supply of finance in pace with increased output which has or is occasioning deficit financing in under-developed coun-tries. It is the intention to raise the level of output rather than to keep pace with it which seems to be the frequent explana-tion.

The suggestion is that when governments create money for economic development it is not the same thing as creating money to fight a war. After all, investments must expand output late or soon. And the economy can only hope to benefit by such expan-sion.

Perhaps we cannot take exception to this argument but it needs some clarification.

A question to ask in relation to deficit financing is whether

the investment it finances increases employment or not. It can, as a very hypothetical case, be possible that additional finance is devoted to such heavily capital using investments that employment rises to a very negligible extent. On the other hand it can be devoted to such labour using investments that employment rises by a considerable amount.

If deficit financing results in negligible employment, the extra purchasing power it releases will go to producers of capital equipment. Provided capital equipment is in short supply and is, of course, procured internally, the price of capital equipment will go up exercising a certain impact upon the price of goods produced by it via a higher cost of production.

The extra income of capital goods producers may or may not be used so as to put further pressure upon prices. The producers may choose to hoard this income : they may spend it on conspicuous consumption or try to expand their business. Except when they hoard, their expenditure should put further pressure upon prices. If they expand their business by insisting upon heavily capital using devices, they aggravate the vicious circle. If they expand by using labour-using devices, they increase employment whose impact upon prices we shall presently examine.

There is another factor here which has to be considered. Since the supply of capital equipment is fixed, deficit financing would merely succeed in diverting it from one use to another. For instance, a machine producing consumers goods may be geared on to the production of machines, and so on. This may aggravate prices without expanding output except after a time lag.

Now if deficit financing unaccompanied by a rise in employment is inflationary, that accompanied by a rise should definitely be so. What will the newly employed labour buy with the purchasing power deficit-financing has put in its hands? If, as is obvious, it will try to draw from the common pool of consumption of those already employed earlier, prices of consumers goods will rise and deficit financing will become inflationary.

Against the above, two points can be made:

(i) We have considered the effect of deficit financing during the incubation period of new investments : we should really look to what happens after that period;

(ii) We have ignored the part which fiscal policy or a vigorous borrowing policy can play in neutralising the aggravating effects of deficit financing upon prices.

As to the second point, let us restate our argument. A certain amount of money has been created to employ say, N_1 people in new investments. The total supply of consumers goods is C and shall remain that until the incubation period is over. Before the employment of N_1 people, just N people, say, were sharing it, each man getting C/N for himself. Now since N_1 more people have acquired purchasing power, the share per man is $C/N + N_1$ which is less than before. If the money wage after additional investment is not lower than before, this must mean a higher price level.

It is argued that this need not be so. We may tax labourers in the new situation or borrow from them to such an extent that each man is left with no more effective purchasing power than is sufficient to buy $C/N + N_1$ at the old prices.

What does this argument mean? As is evident, it means that through taxes and borrowing, we have reduced the real income of the already employed people to such an extent that the newly employed labour can be fed out of their savings. But if taxes and borrowings can do that, where is the point in having deficit financing itself?

As to the first point, we might say that it is hardly relevant. The controversy is whether deficit financing can enable us to avoid taxation and borrowing and yet promote an inflation-less economic growth. If prices have risen, may be only for the duration of the incubation period, deficit financing cannot be said to have promoted economic development without inflation. If prices, on the other hand, have not risen, these are taxation and borrowing which have proved to be real solution.

Only in the following conditions can deficit financing be non-inflationary on its own:

(i) When factors of production and consumers goods are idling for lack of use which is itself either for lack of entre-preneurial enthusiasm or for lack of purchasing power. While production may involve a time-lag even here, in so far as there are stocks of goods waiting to be bought, extra purchasing power need not put a pressure upon the prices.

This is what happens in midst of a depression.

(ii) When expansion in output synchronises with an expansion of labour and the new output has enought of consumers goods to satisfy the demand of the additionally employed at the current money wage. But this implies production without a time lag.

The type of investment which comes nearest to these conditions is the labour-using one. Labour perhaps is the only commodity which is perishing for want of use in under-developed countries. And then, labour-using investments could be more quick yielding than the other type.

This does not, however, mean that deficits to finance labour-using investments would leave the prices unaffected. In the first place it may be utterly uneconomic to have investments which use labour only. We may be able to economise capital but not do away with it altogether. But the main thing is that abundance of labour at best assures constancy of wages, not of prices of consumers goods which may still be in short supply. Thus additional employment would still reduce the share of those already employed and increase prices.

Perhaps, the offer of employment (additional) in the rural sector where the unemployed are consuming without producing, could relieve the burden of those already employed if the newly employed agreed to work for just a small addition to their current consumption. In the limiting case, they might agree to work without any addition at all. This would mean absolutely no pressure on the consumption of the older block of employed people. But all this has relevance to the magnitude of deficit financing, not to its merit. For example, in the limiting case when additional employment takes place at a zero real wage (in the sense that there is no emolument offered when the unemployed get engaged in productive activity) there should be no need for any finance to bring about further employment. The more we offer employment in the rural sector at comparatively small additions to the unemployed

labour's current consumption, the less is the amount of finance we need to have a deficit for. The advantage of labour using investments, located in the rural sector is that for any given volume of deficit financing, they will offer larger employment or for any given volume of employment, they will involve a smaller amount of deficit financing.

Labour using investments may have another advantage. By reason of being quick yielding, they may shorten the time lag during which prices are to rise.

A shorter time lag, however, may not shorten the period of inflation if investments do not produce an appropriate quantity of consumers goods after incubation or if money wages have been allowed to rise.

One doubts if under-developed countries are resorting to deficit financing with a view to fostering capital-saving investments. Then perhaps a given magnitude of deficit financing might produce better results both as regards the volume of employment and the period for which inflation is to persist.

One point more: if by some stroke of luck, under-developed areas get a bountiful harvest or better terms of international trade or better international assistance of consumers goods, extra finance would in fact be necessary. In such circumstances, deficit finance need not pull up prices. But this is similar to the case above in which either because of the economic system turning out more goods than before or fresh monetisation of the economy, we want extra finance to lift the goods from the market without depressing prices. We may have an appropriate dose of deficit finance in these circumstances but as before we will have to

stop the banking system from expanding its own money supply. Is'nt it odd for the government to perform through its budget a function which really belongs to the banking system?

Moreover, it is one thing to have deficit financing as a policy for economic development and another as a cover for chancy circumstances.

If governments of under-developed countries have firm assurances that harvests will be better, imports for the same value of exports will be larger, international aid in terms of food and cloth will be forthcoming, the banking system will not indulge in unplanned increases of finance of its own, they can claim deficit financing as a policy of inflationless growth.

But this is the same as the two conditions of inflationless deficit financing mentioned above. As long as extra employment or extra purchasing power is prevented from drawing from the consumption pool of the old block of employed persons, either because fresh investments supplying consumers goods have negligible incubation periods or consumers goods exist for reasons of Nature's or international bounty or better terms of foreign trade deficit financing does well indeed.

The trouble arises from the fact that protagonists of deficit finance want it to be favoured even when there is shortage of consumers goods, when Nature or humanity abroad are not very bountiful, when terms of trade are not necessarily better and fresh investments almost invariably involve a time lag.

In such circumstances deficit financing has no locus standi except as policy of inflation and suffers from the same faults from which any such policy would suffer. Fiscal policy can do

the same job in a less wasteful and more discriminating manner.

Two more complications:

(i) Deficit financing would render it difficult for the government to prevent additional output of consumers goods from going into higher consumption of the currently employed.

(ii) It would improve the liquidity position of the commercial banks and accentuate their urge to expand money supply and make more profits.

If the intention is to have further employment without raising the level of real wages, we have the problem of mobilising ΔC the increase in consumers' goods supply as a result of fresh investment through measures of fiscal policy or borrowing in such a way that, as far as possible, very little is frittered away in a higher consumption of the peasants or the profit earners. But deficit financing and a tough fiscal policy or a vigorous borrowing policy go ill together. The former appears in the picture because the latter is being avoided. In other words, with a policy of deficit financing a government will have weakened its case to go as far as it should or could, in controlling real consumption through borrowing and taxation.

In fact, if we are thinking of an effective borrowing programme, deficit financing as a policy of inflation creates a serious difficulty. For any lender, inflation would mean a progressive decline in the real value of the money lent. On the other hand, it will also mean a decline in the real value of the compensation offered to the lender in the shape of interest. This is opposite of being conducive to an effective borrowing programme. For any

given level of money interest rates we can, in such circumstances, only hope to make the lenders less and not more enthusiastic to lend than before.

The other complication of deficit financing is its impact upon the willingness of the banks to lend. Government borrowing improves commercial banks' liquidity and naturally drives them to expand credit. We have seen above that the situation in which deficit financing can be non-inflationary is that where deficit financing covers expanded supply of consumers goods. But if it has to do that well, it should prevent expansion of finance from the side of the banking system. Does'nt that become still more difficult when the banks find that they have accumulated unnecessary liquidity and must find borrowers?

However, if under-developed countries must pursue a policy of <u>inflation</u> to accelerate economic development, deficit financing through governments should be better than bank financing through private entrepreneurs unless the direction of the latter's activity into socially desirable channels can be effectively done. An ordinary liberal money policy might be frittered away in speculation, in the acquisition of luxurious buildings, in creating artificial shortage of consumers goods, raw material etc.

For reasons given later, underdeveloped countries should avoid the temptation of economic development through inflation. However, if they do that, the burden of mobilising resources would fall on taxation rather than on monetary policy. Abandonment of liberal money policy, in other words, pre-supposes a change in taxation policy as well.

The tax system which normally obtains everywhere including underdeveloped economies has income tax and indirect taxes as its main constituents. Now the trouble with income tax is that it handicaps saving and encourages consumption more than it handicaps consumption and encourages savings. In fact the more progressive income tax is, the more it does that. And if progressive income tax encourages evasion, it does that with a greater vengeance. In countries, which have been the text book of our economic policy the problem, by and large, has been to increase consumption since savings take care of themselves via increased production induced by increased consumption. It is partly because our economy cannot produce such an elastic supply curve of output that we have the task of accelerating our economic development. No wonder, therefore, that whereas for a developed competitive economy progressive, taxation of income can be a suitable mainstay to taxation policy, for an under-developed economy like India it cannot be. At any rate, income tax may not restrict consumption the way we would like it to do to meet the present challenge.[2]

What about indirect taxes? Normally we depend upon these taxes to regulate if not to control consumption. But indirect taxes cannot be effective except where rising income does not enable consumers to counter them by a higher paying capacity. Thus indirect taxes restrict the fixed income groups' consumption more effectively than the variable income groups. In other words it restricts consumption of a people whose consumption in any case is not rising and fails to restrict that of the people

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1. Indian Public Finances: R.N. Bhargava, 1962, p. 59.

who because they can easily pay indirect taxes will, naturally, increase their consumption since their incomes are higher. If prices are rising, the fixed income groups consumption falls and the variable income groups consumption rises even more than it would have done with indirect taxes. In situtions of rising prices, therefore, indirect taxes mean a double tragedy for the fixed income groups but a sort of a farce for the variable income groups. They do give the government more revenue, but so far as reducing consumption is concerned, they do not even approximate the position we would like to achieve.

There is another difficulty with indirect taxes. They rest on a classsication of commodities between luxuries, comforts and necessaries which cannot be unambiguously defined. The same commodity can be a luxury for one group of consumers and should therefore, be heavily taxed and a comfort or a necessity for another group and should therefore be lightly taxed. The government can insist upon interpreting taxed commodities as luxuries but when there is an almost unquenchable thirst for resources and the government has to go on expanding the tax net, the conflict mentioned above becomes more and more compelling and has to be resolved by declaring more commodities as 'luxuries'. And so on till ultimately the difference between luxuries, comforts and necessaries gets completely blurred and the basis of indirect taxes becomes wholly arbitrary. It is difficult to imagine how we can extricate ourselves from this vicious circle of inequity if indirect taxes continue to be the mainstay of the

government revenues.[3] The revenue aspect of taxation is important but when we are thinking of a prolonged period of sacrifice, the equity aspect is also no less important. No one has ever suggested that indirect taxes have the virtue of being equitable. It does not make them equitable if we argue that after all the masses or their progeny will get back in the shape of economic development more than what they are sacrificing today in the form of taxes. In the first place what assurance is there that this will happen in the near future if it has not happened thus far? Secondly, the problem is not of weighing present sacrifice as against future gains; it is that of distributing present sacrifice equitably. Indirect taxes not only do not solve the problem, they actually aggravate it.

That any tax system must have indirect taxes also is true. But they serve more as a balancing factor and less as the mainstay of the system. By and large, marginal requirements of revenue can be met by raising indirect taxes here and there but when revenues are needed to the tune of such amounts as are involved in development, indirect taxes are bound to put to serious strain the

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3. "Examination of fifty-five countries covered by U.N. data (U.N. Statistical Year Book, 1959) showed that the relative importance of taxes on income and wealth, as a proportion of Central Government revenue, was markedly less in the under-developed territories. For instance, there were six countries which derived less than 10% of their revenue from direct taxes- Sudan, Guatemala, Haiti, Iran, Jordan, Thailand. On the other hand, there were only six countries which derived more than 50% of their revenue in this way - Canada, U.S.A., Netherlands, U.K., Australia, and Newzealand. Alternatively, if we look at those raising less than 20% in direct taxes, we find nineteen countries in all, every one being a member of the under-developed class."
A.R. Prest, Public Finance in Under-developed Countries, pp. 27, 28.

equitable character of our tax system. In any case, as we already have seen above, they do not succeed in cutting our consumption to whatever size we want in the light of our circumstances.

That the richer countries also have a similar system is an argument against rather than in favour of our adopting it ourselves. The difference between a situation where consumption is to be raised and that where it is to be kept as low as possible is a difference of opposites. Broadly speaking then either a certain tax system suits us in which case it does not suit the richer countries or it suits them in which case it does not suit us.

The suggestion for tackling consumption in a more direct manner than hitherto should not be taken to mean an abandonment of income and indirect taxes.[4] A tax system no matter what the conditions it is dealing with has to comprise a number of taxes at the same time. However, it is the emphasis given to particular taxes which may be questioned.

It has to be conceded at once that the change over to a system where we attempt a more direct attack on consumption is extremely difficult. As much as about 37% of consumption in India is non-monetised. Administratively such a tax system as attacks consumption is directly likely to be vaxations[5] and uneconomical in the earlier stages. But the change over appears necessary if taxation policy has to help in maximum mobilisation of real resources for economic development.

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4. Mr. Kaldor's tax proposals contained in <u>Indian Tax Reform Report of a Survey</u>, 1956, rest on this assumption.
5. <u>Public Finance in Under-developed Countries</u>: A.R. Prest, 1962, p. 39.

In India, suggestions have been made to rescue the current tax system which does not appear very helpful in controlling consumption and promoting real savings by suggesting that the incomes in the lower and middle ranges should be more heavily taxed since the current rates of income tax relating to such incomes in the country are far lower than those in richer countries.[6] In the first place, comparisons such as these are not entirely proper. Even a lower income in the United States might be higher than a middle income in our own country. And if taxable capacity is to be measured by the level of our real incomes, vis-a-vis those in the United States, there might be a case for granting tax concessions to lower and certain middle income groups rather than for imposing more taxes on them. There is another consideration which should be borne in mind. The lower and middle income groups will include fixed income groups also whose real income has been suffering an almost continuous set back for a pretty long time. Heavier taxes on middle and lower incomes will be particularly unfair to this class of people. In any case, even with heavier taxes on middle incomes our basic difficulty of being unable to cut consumption to size would remain since that difficulty is bound up with the nature of our attack on consumption rather than with the rates of income tax.

As for taxation of the agricultural sector, we have already seen above that there is a considerable amount of non-monetised consumption going on in the country. Such consumption is naturally to be found in the agricultural sector where peasants are their

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6. Indian Tax Structure and Economic Development: G.S. Sahota, 1961, p. x (Editor's Introduction).

own employers and where marketable surplus is the balance left over after the peasants have made due provision for themselves and their families. In such circumstances, one might say, a tax in kind[7] might be more effective for mobilising resources than money taxes.

Whatever we might to do to make the thing practical, a rationalisation of tax systems in under-developed countries is necessary if monetary policy is to be saved from the wholly misplaced responsbilities of mobilising real resources. That the raising of interest rates which would follow abandonment of a liberal money policy might persuade people to save larger amounts than before is possible. But we cannot lay as much store by such a possibility in a poor economy as might be imagined. So that in such an economy it is taxation policy which has to be the principal instrument of resource creation and mobilisation and not monetary policy.

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7. The Financing of Economic Development: Shanti Kumar Ghosh, 1962, p. 35.

CHAPTER 8

INFLATIONARY MONETARY POLICY AND ECONOMIC DEVELOPMENT

Should monetary policy aim at avoiding inflation at all? Is not inflation itself a solution of the problem of growth with stability? If it is, does this not go in favour of a liberal money policy?

Normally two main arguments are cited in support of an inflationary monetary policy:

(i) One is that when wages and other consumer incomes do not rise as fast as prices, this releases resources from the consumption of the people which can be used for raising the level of investment;

(ii) The other is that just when this is happening, currently rising profits will induce entrepreneurs to look to future with optimism.

The first situation means that resources for investment come to be released; the second means that the necessary psychology for the investment of the newly released resources is also created.

Let us examine the first argument.

Ordinarily forced reduction in consumption is supposed to release labour and capital from consumers' goods industries and let them be available for additional investment.

In under-developed countries, we obviously do not need to worry about releasing labour from consumption because there is

plenty of excess labour supply. But the extent to which there is likely to be a gain on the score of skilled labour and trained technical personnel would be perhaps determined by the extent to which these are in fact used in the production of workers' and peasants' consumption.

Will inflation release capital? Not so far as foreign exchange is concerned. Inflation at home unaccompanied by inflation abroad means that foreign goods have a more attractive value and this tends to lower, not to raise the foreign exchange earnings at home.

Even if it is suggested that this does not happen because home products are not competing with imports or because world prices are rising at the same or higher rate than home prices, there is a snag here. Foreign goods in under-developed countries are used by peasants or working classes to a very negligible extent. When domestic price level is raised with a view to restraining consumption of those already employed amongst these groups, it will have a negligible effect on foreign savings. On the other hand, since private capitalist consumption will increase as a result of inflation, there will be a tendency towards expenditure, rather than saving, of foreign earnings because private capitalists might be the major users of imported consumers' goods.

That the private capitalist expenditure on consumption would increase is not difficult to see. For any marginal investment planned, inflation will normally have to produce forced savings which are greater than this investment by the amount of increase in private capitalist consumption, unless we are assuming that the marginal propensity to consume of the capitalists is zero.

If N_1 people are proposed to be additionally employed at a real wage W_1, X_1 represents the increment in the private capitalist consumption and C_1 the consumption which those already employed have to forego, then

$$C_1 = X_1 + W_1 N_1$$

It can be seen that X_1 might put extra pressure on foreign consumers' goods and therefore on foreign exchange.

The value of X_1 can be changed by weapons of fiscal or monetary policy, the former involving compulsion, the latter persuasion. And there is certainly no reason why these weapons should not be boldly wielded. But as facts are at present, they seem to be, especially the weapon of fiscal policy, better wielded in developed rather than in under-developed economies. With high rates of taxation and the tendency towards building up of corporate profits, the United States economy, for example, would be in a better position to control the value of X_1 than the under-developed countries are. In most of the latter, marginal taxation is not very high and since the economy is not at that high stage of development at which the United States economy is, the tendency towards expansion of corporate profits is also greatly limited. As long as marginal taxation on consumption is not cent per cent, or monetary policy is not vigorous enough to persuade people to save every pie of that which remains after the taxation of marginal income, X_1 will be positive and will exercise an impact upon the demand for foreign goods.

Perhaps direct exchange control is a solution. But it does not by itself reduce X_1 to zero. Such control will divert money

from foreign goods to local goods and make matters worse so far as the latter's prices are concerned.

What about capital other than foreign exchange? The extent to which inflation will succeed in releasing this capital will depend upon the nature of consumers' goods affected. However, since chances are that certain consumers' goods which are not absolutely essential for life will go out of the demand of those already employed, part of the capital used in their production will be available for further investment. But it is only a part which will be so available because some of it must still be used for satisfying the increased consumption of the profit earners. For the same reason, the gain on the score of skilled labour and trained technical personnel will also be limited. However since both these gains will be related to the reduction in total consumption of those already employed, we may now turn to the possibilities which exist on this score.

The advantage attributed to inflation that it reduces the burden of National Debt is not of much relevance here. If governments are left out as a source of savings and enterprise, this advantage may even go against the immediate object of raising savings because inflation raises the real income of creditors who might be the only source of savings in the economy. But this is too unrealistic. The government and other debtors may be a powerful source of enterprise and capital. There is, however, one thing to be remembered here: this argument is valid for old debt; not for the current one. If a debt is being currently contracted because inflation must synchronise with increased efforts at

economic development, its real value will be less than if price would not have risen. And it may well be that in under-developed economies the volume of current national debt is on the increase.

However, the basic question is whether the redistribution of real income between debtors and creditors is a redistribution between consumers and producers or between producers and producers. If the latter, it hardly matters whether the value of debt was rising or falling. Inflation would rather be indifferent to this change in so far as its impact upon forced savings is concerned.

There is no doubt that inflation will reduce middle class consumption because middle class money incomes are more or less fixed but the proportion of people belonging to this class in under-developed countries, if we exclude merchants and petty traders, is much smaller than in developed ones. As for merchants and petty traders, their incomes should not be less variable than those of manufacturers and wholesalers.

So far as decline in real wages is concerned, the confusion in economic policy in most under-developed countries may not hold out any good prospect. Efforts are deliberately made to improve the lot of workers already employed. Not that this is a bad thing. Industrial workers in under-developed countries can hardly be regarded as well paid. But where is the point in letting workers improve their lot and pursuing a policy of inflation at the same time? If the object is to let the workers remain at the level of real income they are currently enjoying, that can be better done by keeping the price level down to its current level.

There is another argument why the gain from the reduction in

real wages may not be very substantial. It arises from the limits up to which the already low level of real wages can be pulled down without serious socio-political consequences. Owing to an ever increasing supply of labour in relation to demand, wages might be almost close to the subsistence level. The only solution is to prove to the worker that when his own meals are being cut, others' are, at least, not being allowed to increase. Without such a proof and with an economic policy of confusion, inflation may strengthen trade unions and defeat the object of releasing greater resources for investment through a reduction in real wages.

The forced savings from the agricultural sector are, equally if not more, uncertain. The more is this sector self-sufficient and non-monetised, the less is the chance of its being forced to save. However, since we know that a part of agricultural produce does flow out to the internal industrial sector as well to the outside world, a certain impact of inflation upon this sector is unavoidable.

But the wage profit dichotomy may not be as readily applicable here as in the industrial sector and so we might analyse this impact on a slightly different basis.

Let us suppose that:

(i) the agricultural sector's consumption of its own product does not exchange for money and is therefore, unaffected;

(ii) this sector does not buy any producers' goods from the industrial sector;

(iii) its provision for depreciation and replacement is made out of its physical produce, not out of its money earnings.

Let us also suppose that A is the surplus of this sector's

output which is sold to the industrial sector at an average price p_a and that B is the surplus which is exported. Let the average price of exports be p_b.[1] If the consumers' goods which this sector buys from the industrial sector are equal to Y and their price is p_y, the money saving of the agricultural sector, S_a

$$= p_a A + p_b B - p_y Y$$

from which $$p_y Y = p_a A + p_b B - S_a$$

or $$Y = \frac{p_a A + p_b B - S_a}{p_y} \quad \ldots (1)$$

The question is whether inflation will have a tendency to reduce Y. The numerator on the right hand side of equation (1) is a measure of the agricultural sector's expenditure on industrial consumption. If the rate of rise of this expenditure is equal to the rate of rise of the price of industrial consumers' goods, inflation will leave agricultural consumption entirely unaffected while if the former rate is higher than the latter, agricultural consumption will rise. It is only when the rate of rise of the agricultural sector's expenditure on industrial consumption is less than the rate of rise of the price of industrial consumers' goods that inflation will have succeeded in releasing consumers' goods from the agricultural sector.

One possibility where this may happen is that in which p_a the price of agricultural surplus sold to the industrial sector is rising at the same or lower rate than that at which p_y is rising. But for this we have to assume a constant money income from exports and a constant saving. But in case p_a is lower than

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1. We assume these prices to be net of taxes.

p_y, the gain on the real wage side in the industrial sector may be poorer. It will mean, for example, that food is not as costly as cloth is. And food constitutes a major proportion of an industrial labourer's budget. He will obviously stint more if the major part of his budget was affected rather than the minor one. So when p_a is rising less rapidly than p_y, these assumptions by themselves may not be enough to warrantm a reduction in the agricultural sector's consumption. The conclusion will depend upon the precise amount by which the agricultural sector's income from the industrial sector rises which itself will depend upon the degree of difference between the rates of rise of p_a and p_y.

So far as p_a is concerned, the magnitude of its rise will be influenced by the extent to which increased expenditure resulting from inflation is employment creating in the industrial sector. But it may also be influenced by bad harvests, hoarding and speculation. Additional employment will increase the demand for agricultural surplus while bad harvests, hoarding and speculation will reduce its supply. If all these factors combine, p_a will rise more rapidly than if, say, only additional employment is there.

Even with very simplifying assumptions a definite conclusion does not seem possible. And if we remove these assumptions and consider all the various possibilities of change in A, B, Y, p_a, p_b, p_y and also the savings of the agricultural sector, which we may call, uninvested money surplus, any conclusion is imagineable.

There is, therefore, not a priori reason to suggest that inflation will reduce the agricultural sector's consumption.

On the other hand the likehood is that increased money income in the industrial sector, will, by raising demand for a relatively

unexpanding agricultural output, improve the terms of trade in favour of the agricultural sector and boost up the latter's share of the industrial product.

The agricultural output might lag behind because in the first flush of excitement, the obsession with the idea that development means industrialisation could lead to a relative neglect of agriculture. But more importantly, it might be so because rising of agricultural productivity in midst of the unfortunate circumstances of under-developed countries cannot but take a fair amount of time.

Rising population is yet another factor explaining why the agricultural sector's terms of trade might be better. A rising population would progressively reduce the agricultural surplus going to the industrial sector, push up ppices and increase the income accruing to the agricultural sector. This is most likely to happen if this surplus is a commodity like food for which the industrial sector's elasticity of demand is less than unity.

If inflation increases the agricultural sector's share of the industrial product, the forced savings of the workers in the industrial sector, assuming that the workers are in fact stinting, would be

$X_1 + W_1 N_1 + Y_1$, where Y_1 is the industrial workers' consumption lost to the agricultural sector

Except for $W_1 N_1$ which is the real wage bill of the newly employed, the rest, i.e., $X_1 + Y_1$ is being wasted in increased consumption of certain groups of people.

We have already considered whether X_1 can be mobilised through

fiscal policy. What about mopping up of Y_1?

The facts at the moment are that fiscal policy in under-developed countries is even weaker so far as the treatment of the agricultural sector is concerned.

The rural sector in India, which is responsible for 70 per cent of the national product, yields less than 40 per cent of the total tax revenue. The Taxation Enquiry Commission had estimated that persons in the expenditure group Rs 1 - 50 per month, in the rural sector, pay about 2.2 per cent of their total expenditure as indirect taxes; but those in the groups Rs 101 - 150 and Rs 151 - 300 per month pay only 0.5 and 0.6 per cent more respectively than the lowest group. Dr. K.N. Raj's view is that we could "double the tax revenues from the rural sectors at even the existing levels of income".[2]

If fiscal policy can be really so strong as to render the marginal consumption of the agricultural sector (like that of the profit earners in the industrial sector) zero, we would have obtained the maximum benefits from forced savings. And yet, if that can be done, inflation becomes unnecessary. After all, the resort to inflation results from our failure to wield the tax weapon as boldly as is needed. However, since inflation involves leakages and waste, which cannot be prevented except by a bold return to fiscal policy, it is the latter which emerges as the real solution.

However, even with a hundred per cent taxation of marginal consumption of profit earners, fiscal policy may find it hard to satisfy the principle of equity.

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2. "Approaches to the Third Plan" - India News, April, 1959.

Let us start with a situation where there is no inflation and suppose that two persons A and B set aside Kx and x units of their real income respectively for consumption. A is the profit earner and B is the labourer so that $Kx > x$, i.e., K has a value greater than 1. Since inflation is supposed to make A a gainer and B a loser, we will henceforth call A and B gainer and loser respectively.

Let the proportion of tax before inflation taken from the loser be α % while that taken from the gainer be $r\alpha$ % where r too is a quantity greater than 1.

Now the consumption, after tax, of the gainer will be

$$Kx - \frac{r\alpha\, K.x}{100} = \frac{Kx\,(100 - r\alpha)}{100}$$

That of the loser will be

$$x - \frac{\alpha x}{100} = \frac{x(100 - \alpha)}{100}$$

so that the ratio of the consumptions of the gainer and the loser before inflation will be $\frac{K(100 - r\alpha)}{(100 - \alpha)}$

If we put $\frac{100 - r\alpha}{100 - \alpha}$ as equal to G, this ratio can be written as KG.

Next we might suppose that inflation has been on and that the loser has sacrificed 'a' amount of consumption from which the gainer is proposing to consume β a where β is less than 1. Thus the newly proposed consumptions of the gainer and the loser are $(Kx + \beta a)$ and $(x - a)$ respectively. Let us assume, as an extreme case, that the gainer has to pay a hundred per cent tax on his additional consumption while the loser gets no relief from the earlier rate of taxation.

In such a case, the consumption of the gainer, after tax, would be

$$(Kx + \beta a) - (\frac{r\alpha . Kx}{100} + \beta a) = \frac{Kx\,(100 - r\alpha)}{100}$$

while that of the loser will be

$$(x - a) - \frac{\alpha(x - a)}{100} = \frac{(x - a)\,(100 - \alpha)}{100} \quad .$$

The new ratio of the consumptions of the gainer and the loser will be $\frac{Kx\,(100 - r\alpha)}{(x-a)\,(100-\alpha)}$

Substituting G for $\frac{100 - r\alpha}{100}$, we have this ratio as $KG\,\frac{x}{x - a}$

Since $x > x - a$, the new ratio is greater than the old one. In fact the more successful inflation is in extracting forced saving out of the loser, the greater is the value of 'a' and the greater is the value 'a' has, the greater $\frac{x}{x-a}$ becomes. With a rising value of $\frac{x}{x-a}$, the multiple by which the new ratio of consumption after tax improves in favour of the gainer also rises. In other words, the gainer will be relatively better off even through his entire gain in consumption, as a result of inflation, is being taken away in taxes. Thus fiscal policy, even with a hundred per cent tax on marginal increase in consumption should find it hard to satisfy the principle of equity in such a situation. The difficulty would increase in almost the same measure in which a policy of inflation succeeds.

The only way out is to increase the tax on marginal consumption to some limit above hundred per cent.

Let us suppose that an extra tax equal to e is also imposed upon the gainer. Then the gainer's consumption after tax would be

$$(Kx + \beta a) - \left(\frac{r\alpha Kx}{100} + \beta a + e \right)$$

$$= \frac{Kx\,(100 - r\alpha) - 100\,e}{100}$$

Since the position of the loser's consumption after tax is the same, the ratio of the consumptions of the gainer and the loser becomes

$$\frac{Kx\,(100 - r\alpha) - 100\,e}{(x - a)\,(100 - \alpha)}$$

$$= \frac{Kx\,(100 - r\alpha)}{(100 - \alpha)\,(x - a)} - \frac{100\,e}{(x - a)\,(100 - \alpha)}$$

Substituting G for $\frac{100 - r\alpha}{100 - \alpha}$ again, the ratio

$$= \frac{KGx}{(x - a)} - \frac{100\,e}{(x - a)\,(100 - \alpha)}$$

If the new ratio of consumptions should not move in favour of the gainer, the least that should happen is that it should equal the old ratio. This means that

$$KG = \frac{xKG}{(x - a)} - \frac{100\,e}{(x - a)\,(100 - \alpha)}$$

Transposing and simplifying, it means that

$$\frac{100\,e}{100 - \alpha} = aKG$$

Substituting for G,

$$100\,e = aK\,(100 - r\alpha)$$

or $$e = \frac{K(100 - r\alpha)}{100}\,a$$

Multiplying and dividing the right hand side by x, we have,

$$e = \frac{Kx\,(100 - r\alpha)}{100} \cdot \frac{a}{x}$$

Now $\frac{Kx\,(100 - r\alpha)}{100}$ is the net consumption of the gainer at the preinflation stage while $\frac{a}{x}$ is the proportion of his preinfla-

tion stage gross consumption which the loser surrenders to the gainer as a consequence of inflation.

Thus, in order that inflation does not make the inequality of net consumptions of the gainer and the loser worse, not only should the gainer be prevented from expanding his consumption by a hundred per cent tax on his marginal consumption; he should be asked to surrender an extra amount equal to the same proportion of his net consumption before inflation which the loss of the loser bears to his own gross consumption of that period. With 'x' remaining the same and 'a' rising with the intensity of inflation, this proportion will rise. And this would mean that e will have to rise too.

A hundred per cent tax on marginal consumption plus surrender of a rising proportion of net consumption of the pre-inflation stage may be very difficult propositions for fiscal authorities in their treatment of the profit earners. And yet inflation clearly creates this problem for them unless they are prepared to ignore one of the most fundamental principles of fiscal policy itself.

We have so far assumed that inflation in the sense of a profit inflation continues to prevail and that profit inflation does not give rise to income inflation. The supposition that until full employment is reached, income inflation need not arise belongs to times when either trade unions had a weak bargaining position or the governments were not so sympathetic to labour interests. We know well that inflation now-a-days does lead to higher money wages even though the degrees by which it does so might differs in individual cases.

Now this by itself need not increase costs of production and thus occasion yet another spurt of inflation if output per head is rising at the same rate as money wages. However we should be cautious about what this means. If output per head rises at the same rate in all branches of the economy, it is all right. But output may actually rise at different rates in different industries. In such a case, a rise of wages at the higher rate might lead to difficulties. The workers in the low paying industries might emulate their more fortunate brethren and succeed in obtaining wages which exceed productivity in these industries. The average of the rise in wages compared with that of the rise in productivity will obviously be greater now. Thus even when starting with a fairly innocent hypothesis, we can land ourselves in a difficult situation.

However if we assume absence of technical progress, the consequence of higher money wages leading to higher costs may not be avoidable.

There can be several sources of a rise in money wages.

First of all, rising prices might, by boosting up entrepreneurial enthusiasm, throw up a rising demand for labour and raise money wages. But this is more likely for under-developed economies rather than for developed ones which have a considerable volume of labour surplus. In the latter, this is likely to be valid largely for skilled labour which does seem to be in short supply. If the unskilled workers emulate the skilled ones to get higher money wages through their trade unions, the rising demand for labour would, in a way, be responsible for higher money wages of all labour. But even so, it may only be too remotely respon-

sible for the rise.

Money wages can also rise independently of the rise in the price level because of the bargaining strength of the trade unions. This is an autonomous rise which can get easily mixed up with wage increases from other sources. But an autonomous rise can get aggravated because workers might try to emulate the profit earners, who should be earning larger profits than before.

Thirdly, wages can rise because workers would insist upon compensation of the loss of their real consumption as a result of higher prices.

Of these three types of wage inflation which have been usually described as demand induced, autonomous and compensatory, it is the last one which is relevant here. The demand induced and the autonomous types of wage inflation might as well be the cause of price inflation but the compensatory type is necessarily a consequence. When prices rise, workers lose a part of their real income which they try to recover and in the process, obtain higher money wages, push up prices, lose again and make further attempts at recovering the loss.

Perhaps we could blame the workers for not being patriotic enough to realise that, with the kind of economic dead-end which their countries have reached, they are bound to be called upon to make a sacrifice. But such attachment of blame goes ill with the surreptitious manner in which sacrifice is sought to be imposed upon them. Unless the governments think that taxation makes sacrifice obvious to the workers while higher prices do not, why should they prefer the latter to the former? And if governments think that way, we cannot complain about the workers'

lack of responsibility. For, a sacrifice which is not supposed to be felt cannot be a responsibility.

There is another contradiction in which governments get involved here. They encourage the principle of cost of living allowances which raise the workers' money income and push prices of commodities higher up without improving their real income. The solution for a declining real income is more goods, not more money. It may be argued that the object of the cost of living allowances is to keep the workers hoping for a recovery even though it is known that the recovery is not immediately possible.

But this makes it still more difficult to persuade the workers to come forward and share the responsibility involved in economic development.

Moreover, it is not bluff without its consequences. The cost of living allowances raise costs and give another push to the price level. Workers, finding their real income lower than what was intended insist upon even higher cost of living allowances. And so on.

Perhaps the most basic consequence of this bluff is that governments get unintentionally committed to rosy promises of more than compensating the worker when real goods are in fact available. But we cannot, as the saying goes, have the cake and eat it too. If part or whole of additional production of consumers' goods is used to improve real wages above their current level we cannot hope to offer as much employment in the economy as could have been possible except by continuing with old policy of inflation. If on the other hand, workers are not compensated for their original

loss of real income, the monetary mirage of the cost of living allowances chasing prices will have to continue.

This is the dilemma of those underdeveloped countries at the moment who have chosen to embark upon the path of inflation.

We could avoid this dilemma by substituting taxes in place of higher prices not because workers will not lose in that case but because workers will lose less and because they will be certain about the sacrifices they have to make in the interest of their own and their progeny's future. An appeal made to the trade unions based on taxes may or may not be successful. But it would certainly have a better chance of being considered than one which is based on inflation and does not want the workers to know that they have to make a sacrifice.

A further aggravating factor which emerges during a period of inflation and is so well known is speculative hoarding of consumers' goods.

If the consumers' goods hoarded or inventories accumulated come from the agricultural sector, the gain to the agricultural sector would be even more than Y_1. Using the earlier identity for the workers' and the middlemen's sacrifice for a given volume of investment, i.e., $W_1 N_1 + X_1 + Y_1$, this would mean that either, assuming the same amount of sacrifice and no change in the profit earners' consumption, less in the volume of investment and the profit earners' consumption, more consumption will have to be sacrificed by the workers and the middle classes.

Since the chances are that the profit earners' consumption would not be affected and that governments will insist upon main-

taining investment, the workers and the middle classes will have to sacrifice more than before thus strengthening the vicious circle of compensatory wage inflation discussed above. If the profit earners' incomes also rise because the rate of rise of prices is greater than the rate of rise of money wages, X_1 will rise and will have a doubly aggravating effect upon the situation.

The effect of inflation so far as the acceleration of the rate of saving in an under-developed economy is concerned may not be as favourable as is imagined. It is felt that whereas under fairly stable monetary conditions, 'savings and net investment in an under-developed country might amount to say, 6 per cent of the national income, under inflationary conditions even with the increased saving of profits, savings and net investment are not likely to exceed, say, 8 per cent of the national income'.[3] In absence of accurate and relevant data, one can only make a guess here. The following table, with all its limitations, does not, however, throw any encouraging light on the role of inflation vis-a-vis capital formation.

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3. Inflation in Relation to Economic Development - E.M. Bernstein and I.G. Patel, I.M.F. Staff Papers, Nov. 1957, p. 376.

Gross Private Investment, as per cent of Gross National Product 1946-48.

Country	1946	1947	1948
Brazil*	10.22	11.22	8.39
Chile**	12.2	11.0	10.5
Columbia***	12.1	12.8	12.1

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* International Monetary Fund compilations. Investment in public construction and inventories is excluded.

** International Monetary Fund compilations. Public and gross domestic is included and changes in inventories are excluded. Operations of large mining companies are excluded from both gross national product and gross investment.

*** From United Nations, National Income Statistics, Supplement 1938-50. Only changes in corporate inventories are included.

Source: I.M.F. Staff Papers, November, 1957, p. 377.

These three countries were, at least during the period covered, a good case of an effort to accelerate capital formation through an expansion of bank credit. But as the table indicates, even though only roughly, the results achieved were certainly not impressive.

While inflation might release certain consumers' goods from the consumption of the people, these goods are unlikely to be food; they will mostly be items of industrial production which while being essential in a sense will not be as essential as food is.

If additional food is not there, additional employment might bid up food prices to such exhorbitant limits that wage earners find a smaller proportion of their income available for the industrial items. This is particularly possible when increased

employment synchronises with bad harvests, the latter reducing supply at a time when the demand for food is going up. The industrial consumers' goods released through inflation might remain unsold, creating other complications.

In any situation where food is in short supply, inflation may be an extremely dangerous policy. And in most under-developed areas food is in short supply.

Per Capita Food Availabilities in Some Under-developed Countries
(1934 - 38) = 100

Country	1950-51	1955-56
Thailand	112	127
Phillipines	109	115
Indonesia	93	101
India	84	95
Pakistan	93	92
Burma	91	88
Ceylon	82	88
Malaya	83	84

Source: World Economic Survey, 1957, United Nations, New York, 1958, p. 73.

Food production per capita in 1963-64 was less than in 1962-63. The World's population was estimated to be rising by about two per cent per year while agricultural production including food, increased only by about one to two per cent per capita. In fact for five years now, there has been no increase in per capita world agricultural production or food production.[4]

4. Report in the Leader of October 6, 1964, on the Annual Review of the Food and Agricultural Organisation (FAO) released on 5th October. 1964.

What about the second argument, namely, that inflation creates an atmosphere of optimism for the future in the business mind?

The first difficulty with this argument is that it is more relevant for a situation where the character of investment is an unimportant consideration. Our object is not just to enthuse private investors but to enthuse them in particular directions. There are even changes that we would want them to feel optimistic in regard to investments which permit only a very guarded optimism.

The second difficulty is that it assumes ready availability of the cooperating factors like capital, trained personnel, raw materials etc. Unusual business enthusiasm can end up in increased prices of these factors because they are in such a short supply.

Private entrepreneurial enthusiasm, if it is there, has to be restrained and discriminating.

The chances, however, are that the mere rise in current prices will not create this enthusiasm. The reasons for an inhibited private business psychology in under-developed countries have already been explained earlier. Referring to the business insecurity prevalent in the mind of the foreign investor in these countries, Professor Von Hofmannsthal says, "Some time before I had calculated that in an average of fifteen years, all foreign investments would be confiscated. It was accordingly necessary for investors to demand an extra 7 per cent of yield annually in order to offset the cost of this insecurity. Recent events had shown that this period must now have been shortened to ten years or even eight. Accordingly the insecurity rate of additional yield which ought to be demanded might be as high as 10 per cent

or even 12 per cent."[5]

There seems no special reason why in the matter of security, the internal investor should view things differently from the foreigner.

Professor Hofmannsthal's study refers to the entrepreneurs' worry in regard to existing investments. But it seems fair to conclude that they would feel much more worried in regard to investments they have yet to make. In midst of such a psychology, the Keynesian marginal afficiency of capital which refers to the profitability of new investments is hardly a useful tool of analysis. And yet this is the tool which seems to be employed in the argument that inflation, by raising business expectations in regard to future profits will induce entrepreneurs to make a higher level of investment than before. Keynes was not dealing with a situation in which the problem facing private entrepreneurs was one of the survival. When such a problem is there, we cannot claim to talk in terms of merely a better or worse 'state of expectation'; in such a situation profit and loss calculations are in fact blurred by the fear that the business itself might not be allowed to remain as an instrument of relatively unlimited personal advantage. And when profit and loss calculations get blurred, marginal efficiency of capital becomes blurred and therefore not much useful as a tool of analysis.

Whatever there might be in the savings argument behind inflation, there is little in the argument relating to business optimism. In fact, if entrepreneurs try to shorten the time

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5. Stability and Progress in the World Economy: edited by Douglas Hague, p. 92.

horizon on existing investments by pushing up their charges to an extra 12 per cent, they make a bad situation worse for themselves. Such extra charge would either lead to an artificial aggravation of prices or a desperate bid to avoid taxes or both. If the former, an average man's real income would suffer a decline in too arbitrary a way and might accentuate his feelings of dissatisfaction. This accentuation would make the atmosphere of insecurity even worse than before. For an average man, the immediate barometer of prosperity is the price level. Any rise in it, apart from what should result from a well calculated policy, is bound to be more seriously taken. On the other hand, a bid to avoid taxes, since it would be countered by greater governmental strictness might leave the entrepreneurs still more unenthusiastic about their business.

By now the reason for governments resorting to inflation might have become clear. It is the inability to pursue fiscal policy vigorously. If this policy could be pursued so as to mobilise all surplus consumption, the maximum for an initial dose of investment will have been obtained. If even then, government resort to inflation with a view to having a larger yet dose of initial investment, it might be utter folly. We cannot, after having reduced everybody's consumption to a minimum, hope to push it further down. If a scope for further reduction really exists, it only means that the tax weapon has not been boldy wielded.

It is difficult to agree with the view that "the rise of prices is .... just a substitute for taxation, since exactly the same result would be achieved without the rise of prices, if the government levied a tax on the community at large and used

the proceeds to pay the workers."[6]

It is not "exactly the same result". For an investment requiring $W_1 N_1$ saving, while taxation might impose upon the people a sacrifice equal to $W_1 N_1$ only, inflation will impose upon them a sacrifice equal to $W_1 N_1 + X_1 + Y_1$.[7] Fiscal policy can be discriminating while inflation is blind. By resorting to inflation, we inflict undue hardship on those with a lower income and needing relief and relieve those with a higher income and not being really as seriously hard pressed. The only justification for inflation can be that it increases profit incomes. But if the marginal propensity to consume of the profit earners is not zero and is not made zero by hundred per cent marginal taxation, it is inevitable that inflation would increase their consumption at a time when for large numbers of people it might actually be going down. That the marginal propensity to consume of the profit earners would, if left to itself, not be zero is obvious enough. In fact, provided what has been said about the inhibited psychology of private entrepreneurs in under-developed countries earlier is correct, such marginal propensity to consume might be very much more than is commonly imagined.[8]

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6. The Theory of Economic Growth: W.A. Lewis, 3rd impression, 1957, p. 219.
7. See page 137 above.
8. "In Brazil, in 1946, the large corporations reinvested 30 to 40 per cent of their profits and redistributed the rest amongst the shareholders. The amount distributed by all the corporations is believed to have amounted to 12,000 million cruzeiros of which one fourth or barely 3,000 million represented various forms of saving (Report of the Joint Brazil-United States Technical Commission, Part III). Taking the figures as a whole, only about 50 per cent of total profits would represent direct or indirect investments."
Economic Development of Latin America and its Principal Problems, U.N., 1950.

Of course if a government deliberately desires to push up capitalist (and peasant) consumption while that of the labourers and middle classes is going down, the matter is different. But it is doubtful if a government interested in promoting the speediest economic development of its economy would be well advised to think of such a policy.

CHAPTER 9

MONETARY POLICY AND THE PROBLEM OF GROWTH WITH STABILITY

Granting that (i) inflation is the consequence of a liberal money policy and that (ii) inflationary monetary policy is undesirable as a growth promoter, can a dear and cautious money policy guarantee by itself control of inflationary tendencies in over-populated economies?

Certainly not. As the following analysis will show, price stability in such economies depends upon such a large number of factors that unless fiscal policy and even direct physical controls also help, prices may not at all be stabilised. However, despite all this help, monetary policy, we will see, may disappoint if it insists upon a liberal approach towards creation of money or credit in the economy.

Now what are the immediate considerations on which price stability in a developing economy would depend?

We will frame the analysis in terms of rising employment rather than investment because in economies of our interest, the productive capital-labour ratio is not so firm that the rates of rise of investment and of employment would necessarily be the same. It is, in other words, possible for employment to rise faster than investment if there is considerable emphasis on such expenditure as health, education, administrative machinery etc., it is also possible for investment to rise faster than employment if there is too much emphasis on heavy industries.

From the analytical point of view, particularly when we are thinking of the short rather than the long period, it may be better, therefore, to relate prices to the rate of growth of wage employment rather than to the rate of growth of investment which seems to be the common practice.

We assume that there are three periods of time, t_0, t_1 and t_2, where t_0 is the period prior to an addition in investment, t_1 is the period of incubation of additional investment in consumers' goods production and t_2 is the period when a second dose of investment could become due.

Let the levels of employment and real wage in t_0 be N and W respectively. Let the increment in employment and the level of real wage in t_1 be N_1 and W_1 respectively (W_1 is less than W because it is out of the stinting of those already employed that N_1 people could be given their jobs). Let $N_1 = N_1a + N_1b$, where N_1a is the ~~amount~~ number of N_1 devoted to the output of investment goods and N_1b is the ~~amount~~ number devoted to the output of consumers' goods.

Let the increment in the supply of consumers' goods at the beginning of t_2 be ΔC.

A difference to consumers' goods supply for further employment will be made according to whether the terms of trade between the industrial and the agricultural sectors are worse or better than, or the same as before. If the industrial sector loses to the agricultural one an amount equal to Y_2, the net increase in consumers' goods supply should be considered as equal to $\Delta C - Y_2$. If the industrial sector gains an amount equal to Y^1_2,

the net increase in consumers' goods supply should be $\Delta C + Y_2'$. If neither loses to the other, ΔC is neither diminished nor increased.

One more factor. If the marginal propensity to consume of the profit earners is not zero, part of ($\Delta C - Y_2$) or ($\Delta C + Y_2'$) or ΔC as the case may be, will go to satisfy increased consumption of the profit earners. Let this amount be designated by X_2 with the interpretation that X_2 will be highest if the industrial sector gains from the agricultural sector and lowest when the industrial sector loses to the latter.

If N_2 is the increment in employment in period t_2, what precise value should it have?

In the first place, the answer to this question will depend upon real wage policy: is it our objective to let labour earn

a) a higher real wage than in t_o,

b) the same real wage as in t_o,

c) the same real wage as in t_1, or

d) a lower real wage than in t_1?

The first two objectives require compensating labour for what it had lost in t_o. The next two objectives do not require that. But the relevant amounts if workers are to be compensated will differ according to whether the employment of N_1 people in t_1 was tax financed or inflation financed. If it was tax financed, the compensation needed would be equal to $W_1 N_1$ because this was the surrender of consumption by the old workers to the newly employed. If it was inflation financed, the consumption will have to be equal to $W_1 N_1 + X_1$. In fact, if we assume, as we are going

to, throughout this analysis, that it is the industrial sector whic loses to the agricultural one and that such a loss must have been incurred during inflation in period t_1 also, the compensation needed will have to be equal to $W_1 N_1 + X_1 + Y_1$, where Y_1 was the workers' consumption surrendered in period t_1 to the agricultural sector.

Assume that we are interested in the first of the four objectives mentioned above; then the value of N_2 (let us call it N_2^1) corresponding to this objective and supposing that the employment in t_1 was tax financed would be

$$\frac{\Delta C - \left\{ X_2 + N (W_1 - W) + (N_1 a + N_1 b) W_1 + Y_2 \right\}}{W_1} \quad \ldots (I)$$

where $W_1 > W$.

This follows from the fact that from $\Delta C - (X_2 + Y_2)$ i.e., what remains after the loss to profit earners' consumption and the agricultural sector, we have to set apart $W_1 N_1$ as a compensation to the losers of the t_o period, $(W - W_1) N_1$ to raise the real wage of N_1 additionally employed people in t_1 to W and $(W_1 - W)(N + N_1)$ to raise the real wage of everybody so far employed to the new higher level W_1. Thus the amount of consumers' goods finally available for additional employment in period t_2, will be

$$\left\{ \Delta C - (X_2 + Y_2) \right\} - \left\{ W_1 N_1 + (W - W_1) N_1 + (W_1 - W)(N + N_1) \right\}$$

Since people are to be employed at the real wage W_1, additional employment will be

$$= \frac{\left\{ \Delta C - (X_2 + Y_2) \right\} - \left\{ W_1 N_1 + (W - W_1) N_1 + (W_1 - W)(N + N_1) \right\}}{W_1}$$

which is, substituting $N_1a + N_1b$ for N_1, the same as (I) above.

The value of N_2 (let us call it N_2'') corresponding to the same first objective but supposing that employment in t_1 was inflation financed would be

$$\frac{\Delta C - \left\{ (X_1 + X_2) + N (W_1 + W) + (N_1a + N_1b) W_1 + (Y_1 + Y_2) \right\}}{W_1} \quad \ldots \text{(Ia)}$$

This distinction between taxation and inflation in period t_1 would be relevant to the second objective too. Only that since $W_1 = W$ here, the value of N_2 (let us call it N_2^{ii}) if employment in t_1 was tax financed would be

$$\frac{\Delta C - \left\{ X_2 + (N_1a + N_1b) W + Y_2 \right\}}{W} \quad \ldots \text{(II)}$$

If employment in t_1 was inflation financed, N_2 (let us call it (N_2^{iii})

$$= \frac{\Delta C - \left\{ (X_1 + X_2) + (N_1a + N_1b) W + Y_2 \right\}}{W} \quad \ldots \text{(IIa)}$$

With the third objective, the value of N_2 (let us call it N_2^{iv}) will be equal to

$$\frac{\Delta C - (X_2 + Y_2)}{W_1} \quad \ldots \text{(III)}$$

If the aim is to have a real wage W_2 (the last of the four aims of real wage policy mentioned above) where $W_2 < W_1$, the amount of consumers goods' available for further employment in period t_2 will be greater than ($\Delta C - X_2 - Y_2$) by $(W_1 - W_2)$ $(N + N_1)$. In other words, the aggregate additional supply of consumers goods at the beginning of t_2 will be

$$\Delta C - (X_2 + Y_2) + (W_1 - W_2)(N_1 + N_2)$$

and the maximum value of N_2 (let us call it N_2^{vi}) will be

$$\frac{\Delta C - (X_1 + X_2) + (W_1 - W_2)\ (N + N_1a + N_1b)}{W_2} \quad \ldots (IV)$$

It is easy to see that $N_2^{i} > N_2^{ii}$ but that both are less than N_2^{iii} and N_2^{iv}. In between themselves $N_2^{iii} > N_2^{iv}$. While these last two are again less than N_2^{v} and N_2^{vi}, between themselves $N_2^{v} < N_2^{vi}$.

This shows that for a real wage corresponding to the first or second objectives, the level of additional employment will be less if investment in the preceding period was inflation financed than if it was tax financed.

Thus inflation not merely inflicts upon the people a sacrifice which is more than the value of the intended investment; it reduces the volume of additional employment, if the object of economic policy is to let the losers of the preceding period improve their standard of living.

In the extreme case where N_1b is zero, i.e., nobody from amongst those additionally employed in t_1 was working on consumers' goods production, the value of N_2 will be negative except perhaps in the last case. In the last case, if the gain resulting from depressing the real wage rate to a still lower level is frittered away in increased profit earners' consumption or a loss to the agricultural sector, N_2 will be zero; otherwise it will be positive.

In case N_1b is positive, the decision as to the value of N_2 will also rest upon the degrees to which consumers and investment goods production in period t_1 were mechanised. And there are

obviously four possibilities here:

1. Investment goods were produced through capital - using devices; consumers goods through capital saving ones;

2. Both investment and consumers goods were produced through capital-using devices;

3. Investment goods were produced through capital using devices; consumers goods through capital saving ones;

4. Both investment and consumers goods were produced through capital-saving devices.

The precise values of ($N_1a + N_1b$) and ΔC, which are important factors in our analysis, will differ according to differences in these combinations. In the first case, N_1a will tend to be low while N_1b will tend to be high. Also ΔC will tend to be high because for any given volume of capital equipment, capital saving devices will yield a larger total output than capital using devices. In the third case which is very unlikely, N_1a will tend to be high while N_1b will tend to be low. ΔC will be low again because goods are being produced through capital using devices. In the fourth case, $N_1a + N_1b$ and ΔC will all tend to be high.

It is clear from the above analysis that the right addition to employment will depend upon:

1. The real wage policy.

2. The leakage of consumers goods in the form of a higher profit earners' consumption.

3. The terms of trade between industry and agriculture governing the amount of leakage into increased peasants con-

sumption; and

4. The capital intensity of investment.

(2) and (3) will be there even when the employment during the incubation period is tax financed. If, however, financing is done through inflation, they might be doubly augmented.

An important assumption which has been implicit in our analysis may now be stated. It is that the economy in question has unemployed labour so that when additional people are actually employed, the output of consumers goods of the base period does not decline for that reason. In other words C which is the output of consumers goods before any addition to employment remains unaffected.

There is another assumption which seems implied in the above analysis. It is that the level of employment in period t_2 is not limited so much by the capital equipment produced in t_1 as by the amount of consumers goods ΔC. If we propose to continue with a given capital-labour ratio, the value of N_2 gets limited by this ratio itself. We, therefore, assume that the capital labour ratio is elastic and can be made as labour biassed as we like.

Reverting to the value of N_2, so far we have supposed that the marginally employed labour will require the payment of the same real wage as an average labourer. But our assumptions above point to a different possibility.

If on certain conditions people can be said to be unemployed in the agricultural sector even though they eat and live, it means, ignoring the moral side of the matter, we may provide them with jobs without extra emoluments. Their inclusion in marginal employment N_2 will then take place at a zero real wage and N_2 may

have a value equal to infinity.

But this is, if at all, possible only when the rural labour is employed more or less at their present venue of work. Rural population in under-developed countries attaches a great premium to their ties with the family, the land and the village. Any scheme of employment which involves a physical mobility leading to a snapping of these ties will have to offer extra emolument as an inducement. And employment at zero real wage will be impossible.

In fact, even at the same venue of work, an extra emolument may become necessary if new jobs involve work for a larger number of hours than what the labourers were putting in during their unemployment. We have seen before that there is no certainty that work per man in the rural sector diminishes with a rising population. In the natural effort to neutralise deterioration in the cooperating factors labourers may in fact put in more work per man than before. It all depends upon the severity with which the deterioration is taking place. But we obviously cannot be categoric about it.

Thus we may not hope to employ people at a zero real wage except under certain special circumstances. But we need not pay them a full real wage also unless they are shifted to the industrial sector. Such a shifting, however, would cause a leakage of their erstwhile consumption into the pockets of those who are still working on land. Thus while marginal employment in the industrial sector would not be possible except at a full real wage, it would be wasteful in the sense that it would result in an unintended increase of consumption of the rural population.

left behind. By trying to have marginal employment in the agricultural sector we can avoid this waste and have a larger value of the marginal employment itself.

As the above equations show, N_2, other things remaining the same, will have a larger value if the real wage offered to the marginally employed decreases.

With the assumptions of we have made in regard to rural reorganisation and elasticity in the degree of capital intensity of marginal investments, this should be possible. The more wholesome is rural reorganisation and the less is the importance we attach to capital-using devices, the more can the value of marginal employment extend even beyond N_2^{y1} which looked to be our maximum in the above analysis.

It is, therefore, implausible to suggest that there is any single addition to employment which is consistent with the requirement of price stability. There can be all the various levels depending upon real wage policy, leakage into profit earners consumption, terms of trade between industry and agriculture, capital intensity of marginal investments and the degree of rural reorganisation.

The trouble is that under-developed countries may not be able to take the drastic action which maximum economic development demands.

It is only some such inability as can explain why the real wage of labour in these economies has been allowed to rise when the addition could easily be used for a higher yet level of employment.

Changes in Real Wages* in Some Under-developed Countries
(Percentage change from corresponding period of preceding year)

Country	1950	1951	1952	1953	1954	1955	1956
Burma	..	..	7	5	5	..	..
Ceylon	..	6	3	-4	3	..	..
India	-4	4	8	-3	5	12	..
Indonesia	..	..	..	..	9	13	-8
Phillipines	..	..	..	11	5	4	-5

* Refers to general wage level or to wages in manufacturing; wages are monthly, weekly or daily earnings, except for Indonesia, where data refer to minimum rates.

Source: From World Economic Survey, 1957, United Nations, New York, 1958, p. 78.

Similar wastes could be found in increased capitalist and peasant consumption and the complexes relating to capital saving techniques and rural reorganisation.

One word might be said here about the significance of the incubation period t to the problem of a stable economic development. There is no doubt that this period has a great importance. But its importance is not independent of the object of economic policy. In case the object of economic policy is to let real wages remain at their present level, the incubation period will, at best, be psychologically important. Having lost their real incomes through taxes or inflation, the wage earners will hold their patience if there is hope that they will be reimbursed sooner rather than later.

But economic policy aimed at maintaining real wages at their current level may not be agreeable to those who are affected. This is possible in case of labour as well as of the peasants in the

agricultural sector. In such a situation, the incubation period will have more than a psychological significance to the losers. But the value of N_2 consistent with stability will then have to be commensurately reduced.

This points to a factor of enormous importance in the context of development with stability. That is the acquisence of workers and peasants in a well defined policy relating to their respective consumptions. But it will be no use complaining about the lack of such acquisence until the governments of under-developed countries have cleared up their own confusion concerning real wage policy.

If we suppose that ΔC is the expansion occurring in the agricultural sector, the quantities involved might be different but the analysis will be the same.

It may be that part of ΔC goes into the agricultural sector's own consumption. So that if this additional consumption is $\Delta C'_A$ the amount available will be $\Delta C - \Delta C'_A$. Since the agricultural sector's output has increased vis-a-vis the industrial sector's, the terms of trade should go against the agricultural sector and this will mean a gain of some amount, say Y'_2 to the industrial sector.

This gain will be shared by profit earners as well as the workers. Let the amount going to the former be X'_2. As for that going to the latter, we assume that through measures of fiscal policy it can be so mobilised as to conform to any of the objectives of real wage policy mentioned above. Evidently, if this assumption is not fulfilled, the pursuance of the last two objectives viz., keeping real wage constant or depressing it would become difficult in view of the fact that improved terms of trade

with the agricultural sector would have automatically raised the real wage of the already employed workers above the current level.

Thus the net amount available for further employment will be $(\Delta C - \Delta C_A') + (Y_2' - X_2')$, where $(Y_2' - X_2')$ is what is available for use for the workers' benefit from improved terms of trade with the agricultural sector.

Of course, if the agricultural sector consumes all that it has additionally produced, this entire amount would be reduced to zero. When nothing extra changes hands with the industrial sector the terms of trade remain unchanged and Y_2' as well as X_2' which is the industrial profit earners' share of the improvement in the terms of trade disappear. But we are assuming here that the agricultural sector does not consume the whole of ΔC.

Now we can introduce real wage policy again.

If the object is to raise real wages above what they were in t_o, then supposing that employment in t_1 was tax financed,

$$N_2' = \frac{(\Delta C - \Delta C_A') + (Y_2' - X_2') - \left\{N(W_1 - W) + (N_1 a + N_1 b) W_1\right\}}{W_1}$$

If the object of real wage policy remains the same but employment in t_1 was inflation financed,

$$N_2'' = \frac{(\Delta C - \Delta C_A') + (Y_2' - X_2') - \left\{N(W_1 - W) + (N_1 a + N_1 b) W_1 + X_1 + Y_1\right\}}{W_1}$$

If the real wage in period t_2 is to be the same as in t_1, the increment in the level of employment will be

$$\frac{(\Delta C - \Delta C_A') + (Y_2' - X_2') - (N_1 a + N_1 b) W}{W}$$

With the same objective of real wage policy and assuming that employment in t_1 was inflation financed, the increment in

the level of employment will be

$$\frac{(\Delta C - \Delta C_A') + (Y_2' - X_2') - \left\{(N_1 a + N_1 b) W + X_1 + Y_1\right\}}{W}$$

Again, it can be seen that while tax financing of investment in any period increases the employment potential of the economy in a subsequent period, inflation financing reduces it, if, of course, the object of real wage policy is to increase real wages beyond the level in the zero period.

We could similarly work out the employment potential if the object of economic policy is either to keep wages constant or to depress them.

Whether a difference to employment potential will be made if ΔC is produced in the agricultural as against the industrial sector will, given a real wage policy, depend upon the difference between

$$\left\{(\Delta C - Y_2') - (\Delta C_A' + X_2')\right\} \quad \text{and} \quad \left\{\Delta C - (X_2 + Y_2)\right\}$$

If $Y_2' > (\Delta C_A' + X_2') - (X_2 + Y_2)$

the employment potential will be greater if ΔC is produced in the agricultural rather than in the industrial sector.

If $Y_2' < (\Delta C_A' + X_2') - (X_2 + Y_2)$

it will be better to produce consumers' goods in the industrial rather than the agricultural sector.

However, if $Y_2' = (\Delta C_A' + X_2') - (X_2 + Y_2)$

the employment potential would be the same no matter which sector the goods are produced in.

This analysis adds yet another factor to our list of those upon which the additional level of employment would depend. It is

the self-consumption of the agricultural sector. We are all anxious that food production in under-developed countries should expand. But we should make sure that extra production does not go into the self consumption of the agriculturists. That the agriculturist's poverty will justify any such improvement in his standard of living is true. But we would not then be able to turn extra food production to the advantage of economic development which is our main objective.

While we are at the factor of self-consumption and the difference it might make to the marketable surplus of food and other consumers' goods, we might refer to some general factors which tend to affect adversely the marketable surplus of various commodities.

One such factor in the earlier stages of development is the expansion in the number of traders. In most under-developed countries to-day people do regard business as being a more paying proposition than services. But business for an average man in a poor country would ordinarily not mean manufacture so much as trade. It is easier to become a businessman by opening a little shop and stocking a few goods than by building a factory and installing machines in it. However, expansion in the number of petty traders particularly under the pressure of growing unemployment is bound to increase the proportion of output which goes into stocks. The assessment of the results of the First and Second Five Year Plans showed that the contribution of trade to national income was larger than targeted.[1] It is not being

1. Dilemmas of Development, W. Malenbaum, Supplement to "Capital" of 20th December, 1962, p. 9.

suggested that petty traders should not be allowed to earn a modest living for themselves but, certainly, if the number of such traders increases marketable surplus will be adversely affected.

Then there is the improvement which might increasingly be taking place in the economy's distribution system. This improvement reflected in better storage facilities, has at least partly been made possible on account of the fact that trade is by and large gaining in its real income as result of a progressive increase in the prices of commodities. This gain increases the traders' staying capacity which is only another name for his capacity to hold back stocks from the market for a longer time than hitherto. This tendency is naturally helped by governmental policy with its particular insistence on the fact that the legitimate needs of trade are always fully met. In addition, the monetary and fiscal policies of the government enables considerable rise in the general liquidity of the economy. Fiscal policy is not able to mop up black market money effectively. This money naturally becomes available to the traders in case they want it and enables them to keep back their stocks even if the commercial banks are helping them with the necessary finance. In India we have a warehousing corporation whose facilities we want producers and traders to enjoy in increasing measure. One may even feel that governmental policies are deliberately aiming at building up stocks and reducing that proportion of output which is really availabele to the consumers across the counter.

What about the factor of speculation? There can be no doubt that speculation is one of the most important factors behind

withheld stocks of essential commodities. But we should be clear about the true nature of this speculation. Ordinarily speculation is a risky proposition and is, therefore, endowed with a sort of built-in mechanism whereby once stocks have become excessive, they begin to be unloaded for fear of a precipitate decline in prices. But the stockists fully know that they need not entertain any such fear since the Government of an under-developed economy can be brow-beaten into immediate action if prices begin to fall. In fact, it is always much easier to prevent a fall rather than a rise in prices. Moreover, the stockists are sure that on account of Government concern about economic development, the rate of expenditure by the Government would keep on progressively rising. They, therefore, feel secure about the fact that whenever their stocks have to be unloaded, the prices earned by them would in no case be less than those which they had paid. Thus traders' speculation in many under-developed countries is just the opposite of what speculation is normally supposed to be and they know it as well as any one else. The only important thing for them is that they should have the necessary staying capacity. But in most speculative hoardings it is the big traders who play the real mischief, and their staying capacity is considerable.

If we consider an open economy, the extra employment potential will depend upon

(i) the nature of goods exported and imported; and

(ii) the terms of foreign trade.

If the goods exported and imported are only consumers' goods then provided the terms of foreign trade remain the same in t_2 as they were in t_1, no difference to the employment potential of the

economy will be made. Because whatever part of ΔC is exported will be substituted by an equal[2] amount of import. If the terms of foreign trade are better, more will be substituted in place of a given volume of exports and the employment potential will increase. If, however, the terms of foreign trade are worse, the employment potential will be reduced.

If the goods exported are consumers' goods while goods imported are capital equipment, the immediate employment potential will have been reduced anyway. Extra capital equipment will make a difference to the capital intensity of investment, not to the volume of employment in period t_2 which will still be determined by ΔC plus all the various other factors which have been mentioned above.

Of course, capital intensity of investments has already been included in our list above. But in the above analysis, it refers to the capital intensity of investment in period t_1, not in t_2. In so far as an increased import of capital equipment in t_2 makes investments more capital intensive than they might have been, this will have a bearing upon the productivity and the supply of consumers' goods in some subsequent period and through that upon the volume of future employment. But upon the employment in period t_2 of our own analysis, it will not have a bearing. On the other hand, in view of the fact that a certain amount of ΔC will have been lost to the economy, the additional employment potential in period t_2, all other things remaining the same, will have been definitely reduced.

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2. We are avoiding here the difficult problem of measurement and comparison of the values of goods which are different from each other.

There may be some under-developed countries who export consumers goods. But there may be many who export raw materials.

What will be the position of additional employment potential in their case?

Since the assumption so far has been that the economy is in possession of just ΔC but no additional raw material, the question of an increase in raw material export does not arise. And no difference to the employment potential will be made.

But we might now introduce extra supply of raw material by supposing that the incubation period of investment in producers' goods including raw materials synchronises with that of consumers' goods so that at the start of t_2, the economy has ΔC from which it exports nothing and a certain volume of raw material which is more than it needs and is, therefore, exported.

If extra export is done without such deterioration in terms of foreign trade that the entire of it is lost, there will evidently be no gain at all. But this can happen only if the foreign demand for the exported raw material is completely inelastic.

Ordinarily extra export will enable an extra import of either capital equipment or consumers goods and in both cases, the employment potential of the economy will not be reduced. However, if capital equipment is imported, the immediate employment potential as we have seen will not be increased either. But if consumers' goods are imported it should be increased.

The volume of gain here will again depend upon terms of foreign trade which will themselves, in the main, depend upon the income elasticity of demand of the countries demanding the raw materials. This provides yet another factor upon which the

employment potential will depend, viz., the income elasticity of demand of our economy's export abroad.

Where has the maze of the above analysis led us to? Perhaps to many things but basically to the conclusion that in a developing economy the rate of growth of employment which can assure stable prices is a function of a rather long list of factors. And those factors are as varied as the consumption policy (including real wage policy) of the economy, the marginal propensity to consume of the profit earners, the terms of trade between industry and agriculture, the self-consumption in the agricultural sector, the marketable surplus of consumers' goods, the capital intensity of investments, the income elasticity of demand for the exports of our economy, etc. They would not be in order by the mere fact of our abandoning liberal money policy. But with such a policy, the task of bringing them to order would, as has been argued in the preceding pages, become extremely difficult. [Fiscal policy as it is in most under-developed countries cannot discipline consumption of those who benefit by the fruit of a liberal money policy namely inflation. As for the terms of trade between industry and agriculture, the self-consumption in the rural sector, the marketable surplus of consumers' goods and the capital-intensity of investments, they all tend to be so affected by inflation that availability of maximum resources for economic development is jeopardised. On top, there is often an arbitrary redistribution of real income from those who are economically helpless to those who are economically powerful. All this may neither be good for maximum economic development nor for stability.

Thus if the problem of growth with stability is to be

successfully tackled, alongwith the emphasis on investment and production, there has to be a concerted attack on whatever makes for excessive rise in consumption demand and for undue reduction in the marketable surplus of consumers' goods. In this, the best help which monetary policy can render is by agreeing to take a place second to that of taxation policy and physical controls. (This is not to say that monetary policy would be unimportant, but its importance would not be denied from its ability to raise resources for development or to stabilise prices by assuring the right level of employment vis-a-vis marketable surplus to so much as from its avoiding to be the nuisance which it frequently tends to be in poor, resource hungry economies.)

INDIAN MONETARY POLICY

CHAPTER 10

INTEREST RATE POLICY

Have we really been serious about making money dear in the Indian economy?

It is true that as early as 1946-1947, the Reserve Bank had felt doubtful about the desirability of continuing with cheap money policy.[1] But it took four years to raise its rate of interest by a mere half of 1%, since the first increase in Bank rate from 3% (at which level it had ruled through all the economic vicissitudes of the pre-war and post-war years) to 3½%, was effected in November, 1951. For the next rise of half of 1%, the Reserve Bank took about six years since the second change was effected in May, 1957. The third increase in the Bank rate took place in January, 1963 when it was raised from 4% to 4½%. The fourth increase of half of 1% came sooner - on September 25, 1964 when the Bank rate was raised to 5%[2] - perhaps because the earlier increases were too apologetic and half-hearted to have made any significant impact upon the price-level or upon money supply.

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1. Economic Developments in India: 1946-1956, C.D. Deshmukh, p. 41.
2. The Economic Times, September 26, 1964.

Changes in Rates of Discount of Central Banks in Selected Countries

Country	Year	Rate
Ceylon	1950	2.50
	1953	3.00
	1954	2.50
	1959	3.00
	1959	2.50
	1960	4.00
India	1935	3.00
	1951	3.50
	1957	4.00
	1963	4.50
	1964	5.00
Japan	1948	5.11
	1951	5.84
	1955	7.30
	1957	7.67
	1957	8.40
	1958	7.67
	1958	7.30
	1959	6.94
	1959	7.30
	1960	6.94
	1961	6.57
	1961	6.94
	1961	7.30
	1962	6.57
	1963	6.20
Republic of Korea	1950	5.84
	1953	6.57
	1959	7.30
	1960	10.22
	1962	10.22
Phillipines	1950	2.00
	1954	1.50
	1957	2.00
	1957	4.50
	1959	6.50
	1960	6.00
	1960	5.75
	1960	5.00
	1961	3.00
	1962	6.00

Sources: U.N. Statistical Book, 1962, International Financial Statistics, February, 1964, and Economic Times, September 26, 1964.

As against four changes in the discount rate in India, Ceylon effected 5 and Japan 15; Korea effected 4 changes while the Phillipines effected 10. It is not suggested here that under-developed countries should enter into a competition in the matter of changing the Bank rate; nor that those countries which effected such a change believed in dear money policy. But the figures above do show that these other countries did not like to rest on their oars when it came to dealing with inflationary credit effectively. The argument that interest rate changes may make no difference to such credit can go even against the changes the Reserve Bank has already effected during this period. Even one change in the Bank rate suggests that the Central Bank has some faith in its efficacy. Four changes prove the point even more firmly. Thus it is difficult to avoid the inference that the main reason behind the reluctance to change the Bank rate more frequently has not been the feeling that such changes would not make any difference to the demand for credit but that in a developing economy, credit should be cheap rather than dear.

Since 1960 when the Reserve Bank introduced the system of penalty rates of interest, the Bank rate weapon is being more selectively wielded.

In the words of a former Governor of the Reserve Bank of India, Shri H.V.R. Iengar, "........... there was little scope for the extension of selective credit controls or for open market operations. Since the instrument of reserve requirements had already been applied, the only remedy available was some direct restriction on availability of credit from the ultimate lender, namely, the Reserve Bank and penalisation of excess borrowing

therefrom, with some consequent levering up of the interest rate pattern. The choice was between a straight raising of the Bank rate and an increase in the Reserve Bank's lending rate on a slab basis without formal action on Bank rate. The latter was preferred not only to moderate any adverse impact on Government securities, especially since the borrowing programmes of the Central and State Governments had been completed only recently, but also on the consideration that a rise in the average rate of the Bank's lending coupled with limitation of availability of borrowing facilities was likely to prove a more effective restraining measure for credit expansion than a straight rise in the Bank rate".[3]

Since 1960 the bank rate has been used in terms of this scheme in ways indicated by the following tables-

3. Monetary Policy and Economic Growth, p. 198.

At first a scheduled bank was entitled to a basic quota which was half of the average statutory reserves required to be kept by each bank under Section 42(1) of the Reserve Bank of India Act during each week of the preceding quarter. The rate of interest charged on this basic quota was the Bank rate itself, i.e., 4 per cent. If a scheduled bank desired further accommodation, then to the extent of the other half of the average statutory reserves, it could borrow at 5 per cent. For borrowings in excess of 100 per cent of average statutory reserves, a scheduled bank was required to pay 6 per cent.

On January 1, 1962, the scheduled banks were allowed additional borrowing at 4 per cent over and above 50 per cent of the average statutory reserves. This additional borrowing was related to the banks' lending to small-scale industries and co-operatives.

Thinking that the measures of October 1, 1960, and January 1, 1962, were not enough, the Reserve Bank reduced the 4 per cent rate basic quota to only a quarter of the average statutory reserves. It also reduced the quota of accommodation available at 5 per cent from 50 per cent of the average statutory reserves to only 25 per cent of those reserves. On the other hand, rates of interest in excess of 50 per cent of the average statutory reserves were stiffened in the sense that whereas formerly any reasonable amount could be borrowed in excess of 100 per cent of average statutory reserves at 6 per cent, now this rate was permissible only up to the remaining 50 per cent of the average statutory reserves. Beyond that amount, i.e., when borrowings exceeded 100 per cent of average statutory reserves, the chargeable rate of interest was 6.5 per cent.

About four months after, i.e., on October 31, 1962, the Reserve Bank tightened the measures still further by excluding the little advantage which was available to banks because of a liberal treatment of credit to small-scale industries and cooperatives from quotas available at 5 per cent and 6 per cent. If the additional quota for small-scale industries and cooperatives available at 4 per cent was more than the quota available at 5 per cent, the excess was to be deducted from the 6 per cent quota leaving the latter even smaller than before. Also in respect of 6½ per cent accommodation in excess of 100 per cent of statutory reserves, the Reserve Bank would give loan only after a review of individual cases.

When the Bank rate was raised to 4.5 per cent on January 30, 1963, the basic quota available at the Bank rate was raised to 50 per cent of the average statutory reserves though a little earlier it was only 25 per cent. But, of course, earlier the basic quota rate was 4 per cent; now because of an increase in the Bank rate, it was 4½ per cent. The additional amount related to credit to small-scale industries and cooperatives could not be available at 4.5 per cent, though earlier, it was available at 4 per cent. There was no lending at 5 per cent. Instead, for borrowing above the basic quota and up to 100 per cent of the average statutory reserves less the quota available for small-scale industries and cooperatives, the interest chargeable by the Reserve Bank was 6 per cent. Above this limit, lending was to be selectively done at 6.5 per cent.

A little later on March 22, 1963, the Reserve Bank decided to make available at 4.5 per cent, additional quota relating to holdings of eligible usance export bills drawn in Indian rupees. There

was no other material change except that from the accommodation available at 6 per cent, no deduction was to be made in respect of quotas relating to small-scale industries, cooperatives and usance export bills. The policy of encouraging borrowings for certain purposes on non-penal rates was taken one step forward when on April 9, 1963, accommodation above the basic quota at 4.5 per cent was extended to amounts relating to banks' lending to collieries guaranteed under the Guarantee Scheme.

About six months later, the Reserve Bank felt that the restrictions might be slightly liberalised and so on October 30, 1963, the 4.5 per cent basic quota was raised from 50 per cent of the average statutory reserves to 75 per cent of those reserves. Also, additional borrowing at 6 per cent was allowed to be raised from 50 per cent of the average statutory reserves to 75 per cent of those reserves. Further borrowing in excess of 150 per cent of the average statutory reserves was allowed at 6 per cent rather than at 6.5 per cent, after a review of individual cases. In short, marginal increase in borrowing was not viewed with as much alarm as previously.

But the enthusiasm proved short-lived and on March 1964, the Reserve Bank reverted to the arrangements which were in operation immediately before the liberalisation was effected.

On September 26, 1964, when the Bank rate was raised to 6 per cent, the quota system was abolished, but the system of penal rates of interest was retained. The penal rates have now been tagged on to the liquidity of the banks borrowing from the Reserve Bank. Normally banks in India have to maintain a minimum liquidity ratio of 28 per cent in relation to their total demand and time liabili-

ties. It has been provided that for every one per cent decrease in the liquidity ratio, the rate charged on the entire amount of borrowings by a bank from the Reserve Bank will be stepped up by half a per cent.[4] The liquid assets, for purposes of accommodation from the Bank, have been defined as the sum of cash balances with the Bank and other banks, and investments, less borrowings from the Bank and the State Bank of India.[5] The concessions in respect of borrowings for small-scale industries and cooperative sectors hav been withdrawn. The preferential treatment to collieries under the Coal Industry Guarantee Scheme has also been discontinued; only the concessions allowed to banks under the rupee export bill scheme will continue.

While there would be no quotas of credit for the scheduled banks, a limit on the borrowing of the larger Indian and foreign banks from the Reserve Bank has been indirectly imposed. The Bank has set a ceiling of 9 per cent on the rate of interest which such banks can charge on their advances, overdrafts and discounts.[6] This means that these banks will not normally find it worthwhile to borrow from the Reserve Bank beyond a certain point.

Now there are grounds to suspect that whatever little increases in the Bank rate have been effected in India, have been effected not so much for preventing excessive investment as for bringing the Bank rate in alignment with the other rates of interest in the money market. Take, for instance, the change of May 16, 1957. It followed a situation in which the highest call

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4. The Financial Express, September 27, 1964.
5. The Economic Times, September 26, 1964.
6. Ibid.

money rate in Bombay charged by larger banks on inter-bank lendings, ranged between 3½ - 3¾ per cent in the busy season of 1956-57 as against 3 - 3½ per cent in 1955-56 busy season. The financial stringency felt during this season was also brought out by the very narrow groove of 3¼ - 3½ per cent within which the lowest rates fluctuated in contrast to the wider range of 1½ - 3 per cent witnessed in the preceding busy season. The money market situation in Calcutta was no different from that in Bombay and the call money rates charged by banks in that centre were generally higher than in Bombay.[7] Thus the raising of the Bank rate by half a per cent appeared to be intended to avoid its getting out of tune with the trends in the money market.

In 1960, when the Reserve Bank introduced the system of penal rates while still sticking to the 4 per cent Bank rate announced in 1957, the inter-bank call money rate in Bombay had already hardened. In Bombay, the inter-bank call money rate which had remained at 3½ per cent in the first two months of the year ranged about 3½ to 4½ per cent till July when it went up further to 3½ - 4½ per cent as against 3 - 3½ per cent in July 1959. In October, the rate rose sharply to 3½ - 5 per cent. In calcutta, the inter-bank call rate was at 3½ - 4½ per cent and 3½ - 6 per cent in September and October respectively.[8]

At the time of the third rise in the Bank rate in January 1963, the market rates of interest were again tending to be firm and to rise. The call money rate at Bombay had risen to 5 per cent in December 1962; in the same month at Calcutta, the call money

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7. _Trend and Progress of Banking_, 1957, p. 6.
8. _Trend and Progress of Banking_, 1960, p. 22.

rate had risen to 4.98 per cent.[9] As the Currency and Finance report itself puts it "the modifications in the slab rates as well as the general levering up of interest rates in the money and capital markets underlined the need for adjusting the Bank rate in line with the prevailing pattern of interest rates. The Reserve Bank, therefore, raised the Bank rate by ½ per cent to 4½..........."[10]

All these years then the Bank rate appears to have been more a follower and less a leader of the Indian money market.[11] The few increases that it has undergone reflect more an attempt to prevent it from getting out of step with the rest of the interest rate structure than to determine that structure in the light of the fundamental requirements of the economy.[12] Such increases, therefore, cannot be interpreted as a real reversal or abandonment of a liberal money policy.

The following figures relating to rates of interest in different countries provide further evidence of the fact that Indian monetary policy has been based on cheap rather than dear money.

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9. Report on Currency and Finance, 1962-63, p. 42.
10. op. cit., p. 43.
11. "It is Bank rate which sets - and in India which is purported to set - the pace and the pattern. Unfortunately in this country, Bank rate has long since ceased to be a pace setter. In 1957, for example, the raising of Bank rate followed upon the distortions in banks' interest rates resulting from the frenzied competition for Deposits during the previous busy season. So also the raising of Bank rate in January 1963 was resorted to in order to bring the primary rate in conformity with other money market interest rates."
    Indian Finance, April 11, 1964.
12. The Bank-rate increase of September 25, 1964 shows for the first time a realisation of the fact that the Bank rate need not necessarily play a second fiddle. But the increase is so slight and half-hearted that its effectiveness may be lost in midst of the other factors making for inflation. These factors might have become pretty powerful in the meanwhile.

It is interesting to see that call money rates in India are sometimes lower than what they are in France and United Kingdom.[13] As compared to Japan, which is in respect of per capita availability of capital, much richer than India, our call money rates appear to be very low indeed. For example, the Japanese call money rate was more than twice as high as India's in 1960, a little less than twice in 1961, more than twice, in 1962 and 1963.

In a way, such level of interest rates in the industrial sector should not be a matter of dis-satisfaction but in a way, it is not so satisfying also. The satisfaction is due to the fact that the price of finance in the Indian economy is as low as in developed countries. But price of finance should not be entirely unrelated to the availability of real capital. It is not desirable at all if we create the false impression upon the people that capital is abundant when in actual fact it is not.

We have considered already the theoretical implications of the controversy relating to choice of techniques and come to the conclusion that on balance it would be more desirable to encourage capital saving rather than capital - using techniques in over-populated under-developed economies. However, "the effect of low

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13. An effect of our interest rates being equal to or lower than those in advanced countries is "to reduce the import of foreign capital and to increase the drain on foreign exchange as represented by the difference between earnings on investment in India and the rate of interest in India (except to the extent that the earnings are siphoned off to labour by way of higher wages or bonuses)"; P.B.M. in the Economic Weekly, November 7, 1957, p. 1500.

interest rates is to encourage large capital intensive projects - the giant steel mill, the large multi-purpose project, etc., and to discourage the small, less capital intensive project."[14]

The view that a shadow rate of interest, higher than the actual one and reflecting scarcity of real capital could still be made use of in deciding about our investment pattern, does not take us far because as long as the entrepreneurs know that capital would in fact be cheaper than assumed, the shadow price would merely egg them on to an even more liberal use of capital.

An obvious ill-effect of low interest rates is the encouragement it provides for wasteful expenditure in both the public and the private sectors. In the public sector, the waste is reflected in prestige expenditure on buildings, furniture and other paraphernalia connected with bureaucracy. In the private sector, it is reflected in expensive advertisements.[15] Both ways, low interest rates help inflation more than capital formation.

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14. The Case for Higher Interest Rates in India: George Rosen, Commerce, 11th July 1959.
15. Advertising Expenditure in Selected competitive Economies, 1962.

Country		Per capita Advertising Expenditure
Great Britain	..	Rs 125
West Germany	..	Rs 100
Japan	..	Rs 35
Canada	..	Rs 175
France	..	Rs 45
Sweden	..	Rs 160
Italy	..	Rs 15
United States	..	Rs 300

Source: Advertising and Research: Ayaz S. Peerbhoy, p. 15.

We have no estimate of adverticising expenditure in India, but with the 'demonstration effect' of foreign private enterprise on our producers, there is every possibility that it might be considerable especially when finance continues to be cheaply available to them.

A factor bearing upon the level of interest rates and having considerable significance is the rate of profit on capital in the industrial sector. According to a study based on the finances of joint stock companies, "taking weighted average of charges, we arrive at an over-all cost rate of about 5.5 per cent on capital in contrast to an average return on capital earned by these companies of 7.5 per cent".[16] This means that interest levels in 1959 were such as to leave a good margin in the profit earned by these companies. The study was not able to measure expected earnings which would even be higher in the light of proposed Government expenditures on a large scale and the policies aimed at rapid industrialisation of the Indian economy.

The position in respect of profits has, as the following figures will show, generally improved and not worsened with time:-

Profits of Selected Private Limited Companies

	1960 (333 companies)	1961 (501 companies)
1. Profits before tax (percentage increase (+) or decrease (-) per annum)	23.3	19.3
2. Retained profits as percentage of profits before tax	19.7	13.7
3. Gross profits as percentage of total capital employed	11.1	11.8
4. Gross profits as percentage of sales	7.9	7.3

Source: Reserve Bank of India Bulletin, January, 1964.

The margin of profit as measured by the ratio of gross profits to sales, went up from 6.5 per cent in 1960 to 7.3 per

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16. Some Aspects of Industrial Finance in India, George Rosen, 1962, p. 113.

cent in 1961. The profitability of capital also improved during the year with the ratio of gross profits to total capital employed moving up from 10.2 per cent to 11.2 per cent. The increase in profits before tax was also appreciable - 19.3 per cent. The rate of dividend for all the companies taken together worked out higher at 13.7 per cent as against 12.0 per cent for 1960.[17]

These profits are those which are considered for income-tax purposes. If we accept the view, commonly held, that there is a very considerable amount of tax evasion in the country, the actual rates of profit in industry should even be higher.

Mr. Kaldor's estimate of evaded income tax in India was between Rs 200 - 300 crores,[18] while the Central Board of Revenue's estimate is Rs 224 crores. Professor Bhargava's estimate is also almost the same - something between Rs 200 - 300 crores.[19] The point is that as long as evasion is there, and it may be as considerable in higher ranges which are likely to complain of higher interest cost as in the lower ones,[20] profits should be higher than what they are made out to be.

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17. R.B.I. Bulletin, January, 1964, p. 11.
18. Indian Tax Reform, Report of a Survey, p. 105.
19. Indian Public Finance, R.N. Bhargava, p. 79.
20. In India, incomes above Rs 80,000/- a year assessed to tax show a decline of 36.8 per cent between 1951-52 and 1957-58. This shows that at such levels of income, particularly, tax evasion is high.

Income-tax as a Percentage of National Income in India: 1948-49 to 1957-58.

Year	Percentage
1948-49	1.83
1949-50	1.83
1950-51	1.39
1951-52	1.46
1952-53	1.44
1953-54	1.18
1954-55	1.27
1955-56	1.32
1956-57	1.20
1957-58	1.37

Source: Indian Tax Structure and Economic Development; J.S. Sahota, p. 29.

In 1948-49, income-tax receipts were 1.83 per cent of the national income whereas 10 years later when the national income of India was so much higher, they were a much lower proportion of the national income - 1.37 per cent only. This could not be possible (particularly when the Indian income tax rates have been so progressive) except through tax evasion.

It is interesting to find that even a more than 7 per cent rate of interest has not deterred borrowers from borrowing increasing amounts of money from the scheduled banks:-

Advances of Selected Scheduled Banks at Various Rates of Interest.

(In crores of rupees)

Rates of interest	Last Friday of September 1960		Last Friday of December 1961		Last Friday of September 1962		Last Friday of Dec. '62	
	Amount	Per cent to total	Amount	Per cent to total	Amount	Per cent to total	Amount	Per cent to total
Above 6 per cent and upto 7 per cent	120.16	15.2	310.34	35.2	364.21	37.9	377.93	37.8
Over 7 per cent	20.16	2.5	119.98	13.6	148.44	15.4	159.54	16.0

Source: Trend and Progress of Banking in India during the year 1962, p. 16.

The thing is that advances of scheduled banks to industry as a whole have been rising despite a progressively rising rate of interest; they have been rising faster than the advances to other sectors of the economy.

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Advances of Scheduled Banks to Various Sectors of the Indian Economy.

(Shares of each expressed as percentage of total advances)

	1951 Dec.31	1952 Dec.31	1953 Dec.31	1954 Dec.31	1955 Dec.31	1956 Dec.31	1957 Oct.25	1958 Oct.31	1959 Oct.30	1960 Oct.28	1961 Oct.27
Industry	33.5	35.1	34.5	34.3	34.3	38.5	43.6	47.9	44.7	51.2	54.2
Commerce and Trade	52.8	46.7	49.2	49.9	50.1	47.5	42.7	37.6	38.9	29.6	28.6
Agriculture	2.2	4.2	2.4	0.8	1.8	1.7	2.7	2.6	2.7	0.6	0.7
Personal and professional	7.3	7.8	8.7	8.5	8.6	8.5	7.0	8.0	8.4	8.8	8.6
All others	4.2	6.3	5.2	6.5	5.3	3.8	4.0	4.0	4.0	2.5	2.7

Source: Trend and Progress of Banking in India, quoted by D. Bright Singh in Supplement to 'Capital' of 19th December, 1963, p. 129.

At the end of March, 1963, industrial advances were 57 per cent of the total bank credit to all sectors as compared to 53 per cent at the end of April 1961 and 34 per cent at the end of December, 1955. The share of commercial and financial advances declined from 36 per cent at the end of April 1961 to 33 per cent at the end of March, 1963; in December, 1955, the proportion had been as high as 50 per cent. Advances to industries like cotton, jute and other textiles, paper, rubber, chemicals and engineering industries during the period April 1961 to March 1963 increased rapidly. The share of engineering industries in total credit to industry rose from 8.0 per cent to 21.3 per cent and that of chemicals, dyes, paints and pharmaceuticals from 4.4 per cent to 5.6 per cent between December 1951 and March 1963.[21]

Despite the changes in the Bank rate and the introduction of a system of penalty rates, the advances of scheduled banks to industry were, on October 27, 1961, more than half of their total advances whereas on December 31, 1951, they were only about 1/3rd of their total advances. While this can mean many things, it also means that the changes in the rate of interest which were attempted were too insignificant from the point of view of adequate control and regulation of credit in the economy.

There are many arguments which are advanced against the raising of the Bank rate and the other interest rates in the Indian economy.

One argument is that the Indian money market is so unorganised and unintegrated that a higher Bank rate may not affect the

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21. R.B.I. Bulletin, April, 1964, p. 463.

general interest rate structure of the economy and, therefore, the attempt may, ultimately, prove abortive. As pointed out earlier, this will go against even those changes in the Bank rate which have already been tried. It is true that the Indian money market is not as well-knit as money markets in some other countries. But it is not as ill-organised also, as it was, say, some 30 years ago. At that time the unorganised market is supposed to have financed as much as 90 per cent of the internal trade of the country. But now its share is just about 50 per cent.[22] We have today, therefore, a wider field of sensitiveness to Bank rate changes than before.

However, the more important fact is the power with which the Reserve Bank is armed[23] and the prestige which it enjoys in the Indian money market.

The Reserve Bank's prestige, as indeed the prestige of a Central Bank in any under-developed economy is partly due to the fact that in such an economy commercial banks do not enjoy the status or the strength which their counter-parts do in some developed countries. This enables the Central Bank to exercise a certain psychological impact upon the commercial banks which is in

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22. Aspects of Economic Development and Policy: B.K. Madan, 1964, p. 151.
23. "The Reserve Bank has extensive powers of direct regulation of the banking system, under Banking Companies' Act, and combines in itself the functions which in a country like the U.S.A. are distributed among different agencies, such as the Federal Reserve and the Controller of Currency. The Reserve Bank can thus directly influence the lending and investment operations of banks generally or of any class of banks or of an individual bank". S.L.N. Simha, Director-in-charge, Economic Department Reserve Bank of India, in Central Banking in South and East Asia, ed. Sethyn Davies, pp. 34, 35.

addition to its very wide powers. Whether the commercial banks borrow from it or not, the fact that it is its wish that expansion of credit should be restrained is clearly understood. For example, towards the end of June 1957, the Governor of the Reserve Bank stressed the need for banks to reduce outstanding credit and by the end of the slack season they had done so.[24]

Thus, both the regard for the wishes of the Reserve Bank and the fear of its wide powers, should help in making a Bank rate policy effective even if the physical link of borrowing between the Bank and the commercial banks is weak or absent (though in respect of many important commercial banks in India, this would not be so).[25]

An argument against raising interest rates which imports a legitimate social and ethical consideration is that higher interest rates would benefit the rich rentier class by increasing the rent element in their interest incomes.

That this may be so cannot be denied. But we should also remember the other side of the picture. If interest rates are kept low and liberal money attitude has produced inflationary conditions, rising prices would increase the rent element in the rich entrepreneurs' income through the back-door. Provided lenders of the economy benefitting from increased interest rates are from amongst the rich entrepreneurial class, the situation, either way, is more or less the same; only that with low interest rates, increased rent

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24. Op. cit., p. 41.
25. "The position here is more akin to that of countries like Germany and Japan where borrowing from the Central Bank is more frequent and continuous", B.K. Madan, Aspects of Economic Development and Policy, p. 152.

would be surreptitiously earned through higher prices, with high interest rates such rent would be earned in a more obvious and direct manner. The advantage of the latter is that we would be more definite about the undeserved gain of the rich and could locate it more precisely than when it accrues as a result of inflation. Such knowledge should be useful both from the point of view of taxation as well as investment policies.

If the lenders include ordinary people also, the case for higher interest rates becomes stronger from the social or the ethical point of view. For, then, part of the increased rent would go to those sections of the community to which the Government should even otherwise want to do as much economic goods as possible.

What if the lenders are a mixed bag with a preponderance of financial institutions? Much would depend upon who the financial institutions concerned are. Provided they are such a group as the Reserve Bank, the State Bank and the Life Insurance Corporation of India or the Industrial Finance Corporations or the Cooperatives, the increased rent element should have a commensurate social benefit as a compensation since all of them are non-private institutions working with the avowed object of public rather than private goods. In one form or another, their profits would be turned to social advantage and if, at the moment, they are not being used with that end in view, the Government can set things right without much difficulty.

The only financial institutions whose unearned gain from higher interest rates may not be reflected in social benefit are the private commercial banks. But in their case, some such measure as requiring a higher proportion of profit than hitherto to be

added to capital and reserves, might be tried.

So far as the Indian scheduled banks are concerned, in 1955 the percentage of capital and reserves to deposits was 6.79 but in 1959, it was only 3.96. It may be noted that at the end of 1959, the percentage of the commercial banks' capital and reserves in the U.S.A. was 8.97 of their total deposit resources. The corresponding figures for Canada and Germany were 7.7 and 6.6 respectively. Of course, the figures relating to foreign countries are not always strictly comparable with those of our own, because, secret or inner reserves which vary from country to country and may in some cases be formidable, are not taken into account in the computation of these percentages. However, banks in these countries generally maintain reserves at a level which is adequate to meet not only the loss in their loans and advances but also the depreciation in the value of their gilt-edged investments which occur through Bank rate variations.

The capital base of Indian commercial banks itself requires to be strengthened. At the lowest level, it is possible to start a bank in India with as low a capital as Rs 50,000/-. True that if the quality of advances is high and liquidity of banks adequate, augmentation of capital would have little significance except perhaps in respect of term advances which are not yet a feature of Indianbanking. But a strong capital base has its own advantages; it not only functions as a cushion against bad debts; it raises peoples' confidence in banking which may be so necessary in the interests of better deposit mobilization.

Raising the capital base of commercial banks in India may be desirable for another reason also. In view of the fact that banks

can be started with a small amount of capital, it has been possible for people to own a chain of banks in the country. Thus a low capital base has helped concentration of power in fewer hands. In some cases, this power is rather enormous in relation to the capital actually employed. The complaint that in many cases a family or a group has the controlling interest in a bank is now more frequent than before. Strengthening the capital base and ensuring that additional capital is held as widely as possible is the minimum that we should do in order to use banks as helpful tools in the planned economic development of the country.

An amendment to Section 17 of the Banking Companies' Act of 1949 introduced in September 1962 requires that at least 20 per cent of the profit of a banking company should be credited to its reserve fund every year. The banking companies incorporated outside India are also now required to pay 20 per cent of their profits in respect of business transacted in India to the Reserve Bank. Is it not possible to include the rent element resulting from higher interest rates also in the amount credited to the reserves? This could either be done by indicating a fixed sum representing the additional rent income of banks which along with 20 per cent profit has to be credited to the reserves or by raising the percentage of profits to be so credited from 20 to a higher figure.

For such additional rent element as does manage to reach private pockets and is unlikely to be used for social good, we may have no choice but to fall back upon taxation as the most effective means of mopping it up for the people. We have already seen earlier that fiscal policy has in any case to shoulder increasing responsibilities for mobilising resources once cheap money policy

has been abandoned. Of course, the tax weapon has to be of a sort which can minimize leakages into unessential and conspicuous consumption and assure that savings are being forced only where they can and should be made.

One argument against dear money policy is that higher interest rates would produce a decline in security prices and inflict heavy losses on security holders.

Now there are several categories of security holders who can be considered.

First of all there are the banks for whom the book value of assets will go down once security prices have declined. If the valuations of securities for balance-sheet purposes is done on the basis of maturity value instead of market value, there would be no problem. But whether the banks would accept this basis of valuation would, at least, partly depend upon their liquidity position prior to the decline in security prices. This in its turn might depend upon the maturity structure of Government securities, which we can see from the following figures, constitute an overwhelming proportion of the Indian commercial Banks' total investment.

Investment of Scheduled Banks

(Rupees in crores)

As at the end of	Investments	Investment in Government Securities	Proportion of (2) to (1) (Percentages)
	1	2	3
1951	358.12	305.83	85.4
1952	379.69	327.02	86.1
1953	389.69	337.74	86.7
1954	413.85	357.53	86.4
1955	453.53	396.09	87.3
1956	442.39	377.77	85.4
1957	516.18	447.31	87.1
1958	752.98	663.55	88.1
Average 1951-58			86.0

Source: Aspects of Development and Policy: B.K. Madan, 1964, p. 260.

As on March 31, 1962, the maturity wise investments of 81 reporting scheduled banks in Government Securities were as follows:-

	Amount (In Crores of Rs)	Percentages
I Treasury Bills	71.2	11.4
II Securities maturing*		
1. below 5 years	228.8	36.7
2. between 5 and 10 years	242.4	38.8
3. between 10 years and 15 years	62.3	10.0
4. Over 15 years	19.7	3.1

* Face Value.

Source: Trend and Progress of Banking in India, 1962, p. 21.

This means that securities maturing within 10 years were about 87 per cent of the total whereas those maturing after 10 years were about 13 per cent. The loss on the former would be proportionately less than on the latter. But since the latter constitute (we may assume that the maturity structure of Government securities with the scheduled banks has not changed much since 1962) only a small percentage, the total loss on them would not be very considerable. Moreover, inso far as, in the securities maturing within 10 years, treasury bills are about 1/7th of the total, the loss resulting from a decline in security prices would be lower than what it might appear to be

There is one other factor which would tend to minimise the impact of a fall in security prices. The banks might be operating with a liquidity ratio which leaves a margin over statutory requirements. The minimum statutory liquidity ratio now required in India is 28 per cent. However, till 1962, at any rate, the actual liquidity ratio of scheduled banks was above 33 per cent.[26]

As long as a margin over statutory requirements exists, the liquidity ratio can be used to absorb losses in the book value of securities (assuming, of course, that the banks insist upon evaluating them on the basis of the market rather than the maturity value). If need be, the statutory requirement in respect of the liquidity ratio can itself be lowered to allow for a decline in that book value.

Thus fall in security prices should not occasion any serious problem so far as the banking institutions are concerned.

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26. Trend and Progress of Banking in India, 1962, p. 20.

As for companies, the damage can be softened if they used their resources to increase dividend distribution. For then, the loss resulting from the decline in share prices could be partly neutralised. According to one assessment, "most old companies have sufficient resources in the form of past retained profits and current retentions to cushion the impact of higher interest rates on share prices.[27] Some companies like iron and steel, cement and electricity generation whose products are allowed to be sold only at controlled prices might be able to neutralise the loss through higher prices which would be fixed anew in view of the increase in the rate of interest.[28] In a way this is what most companies are likely to attempt. But all of them may not succeed if the demand for their products is not as firm, after the introduction of a dear money policy, as it was when cheap money policy was in vogue.

The damage to individual security holders would depend upon whether they belong to the category of pure wealth owners or to that of speculators. In the context of an under-developed economy like India, the distinction between these two categories would not be entirely unrealistic. There are a large number of wealth owners in India who would like to hold Saving-certificates and other Bonds till maturity. For them income certainty is more important than capital certainty.[29] The question of a capital loss resulting from

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27. Interest Rate Policy: P.B.M. in Economic Weekly, Nov. 14, 1959.
28. Ibid.
29. Mrs. Joan Robinson has suggested that 'widows and orphans' look to income certainty more than to capital certainty (Collected Economic Papers, Volume Two, 1960, p. 251). Poverty stricken people in under-developed countries (and they form an overwhelming majority) should not behave differently.

a fall in security prices does not, therefore, concern them. In fact, they may be gainers if dear money policy is able to reduce the rate at which money has been depreciating in value. For, then a given sum at maturity would represent a higher real income than would be possible with lower interest rates and a more rapid rise of prices.

The case of speculators is, however, different. We may not be able to save them from a loss. But in an economy where the capital market is narrow and where investment is being guided and actively assisted by a Planning Commission, the loss to speculators should not be a sufficient argument against the adoption of a sensible monetary policy.

Moreover, this loss may not really be a loss if the securities have been bought with what in India is currently described as 'black money'.[30] Such money is earned through dubious ways and it is only proper that the speculators are unable to retain it. There have been suggestions that high denomination notes should be demonetised as a method of dealing with black money. May we suggest that a rise in interest rates resulting in a fall in security prices should not prove a less effective method of dealing with the nuisance?

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30. The index of the price of equity shares in India rose from 100 in 1952-53 to 193 in 1961-62, thus indicating an average rate of rise of 10 per cent per annum. After a sudden decline by 17 per cent in 1962-63 probably because of the Chinese aggression and the consequent imposition of heavy taxes, it started rising again and registered a rise of 5 per cent in 1963-64. (The Effects of Inflation in India; A.M. Khusro, <u>The Statesman</u>, October 7, 1964).

On balance, it is therefore difficult to establish that the once-for-all capital loss aspect of a dear money policy is so important that we should refrain from carrying it out. That the loss would be a once-for-all variety is obvious enough. Provided the rate of interest has been fixed so high as to reflect truly the scarcity of real capital, it would be changed only when that scarcity is reduced. But in under-developed countries that would not happen except after sufficient time lags. In the meanwhile, monetary management could well depend upon instruments of credit control other than the Bank rate. In the context of a realistically high Bank rate, such instruments should prove to be far more effective than they have been in the opposite back-ground.

Amongst the advantages of a high Bank rate mentioned, one is that high interest rates in under-developed countries might attract short term foreign capital which they require to relieve pressure on their balance on payments.[31] It is said that behind the raising of the Indian Bank rate to 5 per cent on September 25, 1964, there is the hope of 'short-term funds from abroad coming into India particularly from countries where interest rates are not comparatively so high'.[32] One does not know if this hope will materialise

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31. "....... marked discount rate increases or decreases, by leading to changes in market interest rates, have, at times, been able, although to a much lesser extent than before the war, to exert an influence on the movement of 'short-term capital' between countries, thus contributing to a reduction in foreign-exchange-reserve strains." Peter G. Fousek, Foreign Central Banking: The Instruments of Monetary Policy, November 1957, pp. 23, 24.
32. Financial Express, September, 27, 1964.

since even after the latest increase, the Indian Bank rate does not rest on a very high level. We have already referred to the fact that interest rates in India do not differ much from those in other countries. It is, therefore, doubtful if the rise of a mere half a per cent would create the difference which is tempting enough for foreign lenders. However, if the Bank rate is raised by a bigger margin, we may look forward to some helpful inflow of foreign funds into the country. After all, there might be some non-economic factors also inhibiting the inflow of such funds. They would obviously be better neutralised by a bigger rather than smaller interest differential between India and the lending countries.

From the point of view of controlling the threat to price stability which arises in under-developed countries from speculation in and hoarding of commodities, high interest rates should be particularly useful. Even normal inventory accumulation in developing economies can pose a threat to price stability since, as Professor Lewis has pointed out, 'stocks in existence at any time are between ⅓ and ½ of national income. Hence if national income is increasing by 3 per cent annually, one needs to add to stocks about 1 to 1½ per cent of national income which may be as much as 12 per cent of net investment'.[33] In economies where output is rising rapidly, or at any rate can rise rapidly because ready resources are available, there need be no particular worry about the rate at which stocks are being built. But where economic growth is unbalanced, as in under-developed countries, with accent on capital creation rather

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33. The Theory of Economic Growth: W. Arthur Lewis, p. 212.

than consumers' goods supply, even normal inventory accumulation has to be avoided. If to this normal process, speculation gets added, the threat to price stability becomes very serious indeed. In such circumstances, higher interest rates should be a better help in achieving growth with stability than lower interest rates.[34]

An advantage of high interest rates particularly underlined by the latest increase (September 25, 1964) in the Bank rate in India is that they might assist commercial banks in mobilising larger deposits.[35] ✓

It is interesting to observe that the time deposits of Indian banks have been rising for some years even without any sizeable increase in the Bank rate.

Relative Share of Time and Demand Deposits

(as percentage of total deposits)

Year-end	Time deposits	Demand deposits
1951	37.2	62.8
1952	40.1	59.9
1953	43.0	57.0
1954	40.8	59.2
1955	42.1	56.0
1956	44.8	55.2
1957	51.5	48.5
1958	58.3	41.7
1959	63.3	36.7
1960	60.4	39.6
1961	59.3	40.6

Quoted in 'Bank Deposits and Advances Rise with the Growth of National Income, Supplement to "Capital" of 19th December, 1963, p. 129.

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34. The Pace of Development: R.F. Kahn in The Challenge of Development, Jerusalam, 1957, p. 185.
35. Finance Minister's Speech in Parliament, The Economic Times, September 26, 1964.

From 37.2 per cent of total deposits in 1951, time deposits rose to 59.3 per cent of total deposits in 1961. The rising trend of time deposits continued even till before the increase in the Bank rate to 5 per cent on 25th September 1964. The rise in time deposits in 1962 was of the order of ₹ 149 crores whereas in 1961 it was of the order of ₹ 121 crores.[36] In 1963 time deposits rose again but the rise was of the order of ₹ 103 crores[37] only i.e., it was ₹ 46 crores less than the rise in 1962.[38]

In such a background as this, the raising of the Bank rate to 5 per cent should help in a greater mobilisation of deposits by the banks. But will all this increase in time deposits be necessarily anti-inflationary? The answer would depend upon the impact which rising time deposits exercise on money supply. And, about that impact, as the following analysis will show, nothing categorical can be stated.

First we might suppose that increased time deposits are being held in lieu of demand deposits.

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36. Trend and Progress of Banking in India, 1962, p. 7.
37. Reserve Bank of India Bulletin, April, 1964, p. 464.
38. The set back in time deposits in 1963 was partly due to the fact that certain banks chose to include Savings Deposits in demand rather than in time deposits. They thought of changing the classification because of the liberalisation of the withdrawal facilities for Savings accounts and the introduction of a uniform Statutory reserve requirement of 3 per cent against both time and demand deposits as against the earlier requirement of 5 per cent against demand liabilities and 2 per cent against time liabilities.

Let the present levels of demand and time deposits be OD and OS respectively. We also suppose that tan α measures the legal or conventional reserve-deposit ratio on time deposits while tan β measures such a ratio for demand deposits. So that the present reserves of the banking system on these deposits are SK and DL respectively. We further suppose that the banks do not have excess reserves and would not like to have any.

Let the time deposits rise from OS to OS_1 and demand deposits fall from OD to OD_1. The increment in time deposits, SS_1 is equal to the decrement in demand deposits, DD_1. As a result of a decrease in demand deposits, the banks come to possess excess reserves on those deposits to the extent of LL_1. But they need extra reserves

to the extent of AK_1 for the addition to their time deposits which means that their net excess reserves would be equal to $(LL_1 - AK_1)$.

If AK_1 is less than LL_1, i.e., equal to LL_2, the net extra reserves will be equal to L_1L_2. On the basis of the extra reserve, the banking system can create more demand deposits but as the diagram shows, the total demand deposits even after the expansion would be OD_2 which is less than OD, the original level.

Thus in a situation where the reserve ratio for demand deposits is more than that for time deposits, an increase in time deposits resulting from a diminution of demand deposits will reduce the total volume of demand deposits to a lower level and would cause a contraction in money supply.

If LL_1 is less than AK_1, the reserves released as a result of an initial reduction in demand deposits will be less than sufficient to meet the deposit requirements of expanded time deposits. The demand deposits will have to contract further till $LL_1 = AK_1$. Of course, this further contraction in demand deposits should not go into time deposits otherwise this equality would never be restored.

As a glance at the above diagram will show, the possibility of LL_1 being less than AK_1 will require that the time deposits reserve-ratio line has a greater slope than the demand deposit reserve-ratio line and is above, not below that line. In other words, for a given volume of time deposits, the banking system should hold a larger reserve than for the same volume of demand deposits. This is unlikely.

In case $LL_1 = AK_1$, the slopes of the two lines are the same; they overlap each other and whatever is the reserve required against time deposits is also the reserve required against demand

deposits. In such situations, the demand deposits would be reduced to the extent to which time deposits have gone up; no more, no less. Thus both when the reserve ratio for demand deposits is greater than that for time deposits and when it is equal to it, a shift from demand deposits to time deposits will act in the direction of reducing money supply.

Will it be the same if the people choose to hold extra time deposits at the cost of some money in circulation but not at the cost of demand deposits? Not necessarily.

As before, let the lower line represent the reserve ratio on time deposits and the upper line, the reserve ratio on demand deposits.

The current levels of time and demand deposits are OS and OD respectively. The current amounts of reserve on time and demand deposits are SK and DL respectively.

Let us now suppose that the volume of time deposits goes up by SS_1 which is also the diminution caused in the volume of currency in circulation; the increase in the reserves required to balance the change in time deposits is K_1A. Since SS_1 is greater than K_1A, part of the increment in time deposits will be available to the banking system as an extra reserve for fresh demand deposit expansion. The question of SS_1 being less than K_1A does not arise unless the reserve required to be held against the marginal increase in time deposits is more than hundred per cent which is unlikely.

If $SS_1 = K_1A$, it means that K_1A/SS_1 the reserve ratio on time deposits is equal to one. This will imply that the reserve ratio on time deposits is a hundred per cent.

In that case no part of SS_1 which goes into additional time deposits remains after meeting additional reserve requirements and, therefore, no further expansion of demand deposits is possible. The volume of such deposits remains the same as before viz., OD. The currency in circulation having gone down and the demand deposits remaining the same, the net effect of increased time deposits will be to contract money supply. Thus with a hundred per cent reserve against time deposits, expanded time deposits should mean a reduced supply of money.

However, the most likely case is that in which SS_1 is greater than K_1A so that part of the addition to time deposits is available for demand deposit expansion. If the expansion in demand deposits i.e., DD_1 in the diagram, is more than SS_1, money supply would have

expanded despite an earlier diminution. Otherwise it would either remain stationary or go down. Everything will, as we shall presently see, depend upon the values of the two reserve ratios for time and demand deposits which we might call 'b' and 'a' respectively. If the reduction in currency in circulation is s_1 which is also the addition to time deposits, the extra reserve required would be bs_1. The excess with the banking system would then be $s_1 - bs_1$ and the expansion in demand deposits would be $\frac{s_1 - bs_1}{a}$. The net expansion in money supply would be

= expansion in demand deposits + expansion in currency in circulation.

$$= \frac{s_1 - bs_1}{a} + (- s_1)$$

$$= \frac{s_1 - bs_1 - as_1}{a} = \frac{s_1 (1 - b - a)}{a}$$

It is evident from this equation that if $(a + b) = 1$, the net expansion in money supply would be zero. If however, $(a + b) > 1$ there will be a contraction in money supply because the net expansion would be negative. Only if $(a + b) < 1$, that it will be positive and the change over to time deposits from currency in circulation would cause an expansion in money supply. The chances are that unless the ratios are suitably manipulated, their sum would be less than unity. This means that in absence of a suitable manipulation, a change from money into time deposits would increase the total supply of money in the economy.

What will be the position if part of increased time deposits comes from demand deposits and part of it comes from the currency in circulation? We could, on the basis of our analysis so far, say

that if $(a + b)$ is equal to or greater than one, the increase in time deposits will lead to a contraction in money supply. If $(a + b)$ is equal to one, the change from the currency side will leave net money supply unaffected while the change from the demand deposit side will cause a diminution. So that, on the whole, money supply will have come down to lower level. The same will happen in an accelerated form if $(a + b)$ is greater than one. For then both the change from the currency as well as from the demand deposit side will cause a contraction in the volume of net money supply. If, however, $(a + b)$ is less than one (which is most likely), the impact of change from the currency side will be to raise net money supply while that of a change from demand deposit side will be to lower it. Again any result is possible depending upon the magnitudes of the ratios and the changes concerned.

If the rise in time deposits from demand deposit side is s and that from currency side is s_1, the total reserve requirements for the fresh volume of time deposits will be equal to $b(s + s_1)$. In so far as the reduction in demand deposits has taken place to the extent of s, as amount of reserves are an excess with the banking system on demand deposits now. In so far as s_1 time deposits have been created, the depositors bringing in an equivalent amount of currency, s_1 itself is an addition to the reserves of the banking system. Thus whereas $b(s + s_1)$ is a measure of the reserves the banking system should additionally require on account of time deposits, $(as + s_1)$ is the amount which it actually does have. So the excess reserve of the banking system would be $(as + s_1) - b(s + s_1)$. On the basis of this net excess, the basis banking system could expand demand deposits by $\frac{(as + s_1) - b(s + s_1)}{}$

To find out the net expansion of money supply, we must subtract from this amount the diminutions in demand deposits and the currency in circulation which have already taken place because of the change over to time deposits. These diminutions are s and s_1 respectively. Thus the net expansion of money supply would be

$$= \frac{(as + s_1) - b(s + s_1)}{a} - s - s_1$$

$$= \frac{s_1 (1 - b - a) - bs}{a}$$

This equation confirms what has been said above, namely, that if (a + b) is equal to or greater than one, the volume of money supply would tend to contract. But with (a + b) being less than one, a categorical conclusion is not possible. Everything would depend upon the magnitudes of the switch-overs from demand deposits into time deposits and from currency into time deposits, the former switch-over being deflationary and the latter, inflationary.

In India, since the reserve requirements against demand and time deposits are the same, that is 3 per cent, it would be helpful for price-stability if people can be persuaded to hold time-deposits in lieu of demand deposits. But this pre-supposes that they are holding certain funds in demand deposits unnecessarily which is unlikely except for small marginal amounts. On the other hand, 'currency remains the predominant part of money supply, being about 70 per cent as against 30 per cent of demand deposits'.[39] It may be that one of the reasons why demand deposits have continued

39. Aspects of Economic Development and Policy: B.K. Madan, 1964, p. 151.

to rise alongwith time deposits is that the latter are being held more in lieu of currency and less in lieu of demand deposits.

Demand Deposits of Scheduled Banks

(Excluding inter-bank deposits)

(In Crores of Rupees)

As on last Friday of December	Amount	Annual variation, per cent
1959	668.9	+ 2.9
1960	721.0	+ 7.8
1961	732.6	+ 6.9*
1962	816.9	+11.5
1963	996.9	+22

* Figures represent the variation between December 1960 data collected under Section 42 of the Reserve Bank of India Act and December 1961 data collected under Form XIII under the Banking Companies Act.

Source: (i) Trend and Progress of Banking, 1962, p. 8.
(ii) R.B.I. Bulletin, April, 1964, p. 464.

If the recent changes in the deposit rates,[40] following the rise in the Bank rate to 5 per cent, have induced even larger holdings of time-deposits in lieu of currency in circulation, the capacity of the banks to create money would be further strengthened.

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40. Under the revised schedule of maximum interest rates, banks will pay no interest on deposits up to 14 days. On deposits of 15 days to 45 days, they will pay a maximum of 1.25 per cent and on those of 46 days to 90 days, 2.50 per cent.
The rates on term deposits are: 91 days to six months - 4 per cent, six months to one year - 4.50 per cent; one to two years - 5 per cent, two to three years - 5.25 per cent, three to five years - 5.50 per cent, five to seven years - 6 per cent, seven to nine years - 6.25 per cent and nine years and over - 6.50 per cent.
The Leader, October 3, 1964, p. 2.

CHAPTER 11

OPEN MARKET OPERATIONS AND PUBLIC DEBT POLICY

The Second World War saw a considerable increase in the quantum of India's public debt. Whereas on March 31, 1939, the total rupee debt had stood at Rs 625.62 crores, on March 31, 1946, it had moved into four figures and stood at Rs 1,797.05 crores. This means that as much as Rs 1,171.43 crores had been taken from the public in the form of small savings, treasury bills, 'ways and means' advances etc., for financing the War. Between 1946-47 and 1950-51, there occurred a net outflow of Rs 21 crores, so far as the combined net receipts from market loans of the Centre and the States were concerned. However, at the end of March 1951, total public debt in India had managed to reach the level of Rs 2,561.50 crores.

Since the beginning of planning till 1960-61, public debt had been rising at the rate of 14% per annum as against 28.8% at which rate the net capital formation in the public sector had been rising. From the level of Rs 2,619.69 crores in 1951-52, it jumped up to Rs 6,280.60 crores in 1960-61. If we add two further years, namely, 1961-62 and 1962-63, the level becomes still higher - Rs 7,690.82 crores. And then, against the earlier 14% per annum rate of growth of public debt in the country, we get a rate of growth which is about 50% higher.

The increase in outstanding public debt during the First plan

was about 26.4%. Whereas it was Rs 2,619.69 crores in March 1952, it rose to Rs 3,311.59 crores in March 1956. This implied an increase of Rs 691.90 crores in absolute terms. However, between March 1957 and March 1961, the rise was even more considerable (of the order of about 70.8%) and the total outstanding public debt, which was at the level of Rs 3,676.13 crores in March 1957, shot up to Rs 6,280.60 crores in March 1961. During 1962-63, the total outstanding public debt stood at Rs 7,690.82 crores.

Net Capital Formation in the Public Sector

(rupees in crores)

Year	Net Capital Formation in the Public Sector		Outstanding Publi Debt (at the end of the year)	
	Amount	Index Nos. (1951-52=100)	Amount	Index Nos. (1951-52 = 100)
1	2	3	4	5
1951-52	206.0	100.0	2,619.69	100.0
1952-53	201.0	97.6	2,643.70	100.9
1953-54	259.0	125.7	2,694.62	102.9
1954-55	325.0	157.8	3,039.15	116.0
1955-56	445.0	216.0	3,311.59	126.4
1956-57	572.3	277.8	3,676.13	140.3
1957-58	702.3	340.9	4,216.13	160.9
1958-59	770.2	373.9	4,963.59	189.5
1959-60	762.3	370.0	5,567.64	212.5
1960-61	798.2	387.5	6,280.60	239.7
1961-62	-	-	6,793.94	259.3
1962-63	-	-	7,690.82	293.6

Source: 'Debt Expansion for India's Economic Growth' ; S.B. Sinha, Commerce Annual Number, 1963, p. 114.

Soon after independence, the Reserve Bank of India was faced with the problem of mopping up excess liquidity that had resulted from war finance and of maintaining people's confidence in the gilt-edged. The two problems required more or less opposite actions. The problem of mopping up excess liquidity required sale of securities; that of maintaining security prices required buying of securities. Purchase of securities to stabilise their prices was needed because high prices of commodities were inducing many to invest in commodity stocks and in other investments which had a higher return than gilt-edged and to unload Government Securities and lower their prices. This attitude of the owners of Government securities was very different from what it was in July 1946 when the Government had announced the floatation of the 3% Conversion Loan of 1986. The loan was to be subscribed to by the conversion of the 3½% (non-terminable) Loan for whose redemption necessary notification had already been made. The time for the receipt of applications was between August 15 and October 14, 1946. The loan was issued at par and was not repayable before September 1986. It was subscribed to the tune of Rs 247 crores.

However, with the disappearance of control on a large number of commodities and with an upward movement of prices, people's preferences began to go more against the giltedged than in favour of it.

In August 1947, Mr. C.D. Deshmukh said in the Governor's Report that "having considered all facets of the subject, I was inclined to think that a consolidation of the progress already made towards cheap money was very essential before making any attempts further to cheapen money..... It is being increasingly

recognized that beyond a certain limit, cheap money not only ceases to be beneficial but in certain conditions, for instance when inflation outlives forces th t engendered it, becomes positively harmful to the economy'. Coming as it was from the Governor of the Reserve Bank, it was an important policy statement. The statement could be interpreted to mean a prudent cheap money policy implying neither that the rates of interest would be allowed to be progressively lowered nor that they would not be allowed to rise at all. However, the basic idea was still that of cheap rather than dear money policy.

In November 1947, a new loan offering 2¾% interest was floated. The loan was for Rs 40 crores; its earliest date of maturity was November, 1962; it was issued at par and could be subscribed to in cash as well as by conversion. The rate of interest on the loan was a quarter per cent higher than what it was on a similar loan floated a year earlier and on the face of it indicated a reversal of cheap money policy. But the margin of the rise was too small to permit this to be really called a reversal of that policy. Perhaps, it meant what the Governor of the Reserve Bank wanted it to mean, namely, a consolidation of cheap money policy with a view to avoiding its harmful effects.

Possibly, this slight rise in the rate of interest created expectations of a further rise and, therefore, the loan was not a success. A major part of the conversions came from the Government itself while payment in cash was very unimpressive.

That the Reserve Bank was firm in its policy in respect of Government securities, even though that policy resulted in some

decline in their prices, became evident from the Bank's directive advising the commercial banks in April 1948 to redistribute their port-folio of Government securities from long to short term. The Reserve Bank's idea was that for the continued liquidity of the Banking system, it was more desirable to have a low rather than a high proportion of long-term Government securities in the commercial banks' security port-folio.

This directive reflected two things: (a) the Reserve Bank's willingness to allow the gilt-edged rate to rise and (b) the Reserve Bank's concern about strengthening the liquidity of the commercial banks. In the process, the Reserve Bank produced a situation in which some short period rates of interest also began to rise.

Money Rates in India

Year	Imperial Bank Hundi rate		Bank rate	Call money rate		Bazar bill rate		3 months deposit rate		6 months deposit rate	
	Highest	Lowest		Highest	Lowest	Highest	Lowest	Highest	Lowest	Highest	Lowest
1947-48	3	3	3	½	¼	10	9	1¼	½	1½	¾
1948-49	3½	3	3	1	½	15	9	1½	1	1¾	1¼
1949-50	3½	3½	3	1¾	½	13	10	1¾	1	1¾	1½
1950-51	4	3½	3	1½	½	13	10	2¼	1	2½	1½

Source : Reports on Currency and Finance for the relevant years.

The 'consolidated' cheap money policy was clearly not meant to lower the rates of interest any further; if at all, it was meant to tighten the rates of interest a little, though officially the intention, as reflected in a constant Bank rate, was neither to lower nor to raise the interest rates.

In the meanwhile, the Reserve Bank felt that open market operations should be conducted so as to prevent the long term interest rates from going up too high. Such operations were necessary for another reason too. If people's confidence in Government Securities was shaken, it may be bad from the long period point of view of economic development since, after all, in a developing economy, a Government is bound to bank upon a successful borrowing programme for resources. And so the Reserve Bank kept on buying marketabele Government Securities as and when they came to be unloaded on the market. The result was that the Bank's holding of such securities more than doubled between June 1948 and March 1951.

Partly for the reason that such acquisition of securities was stabilising long-term rate of interest at the cost of increased money supply and partly because the Reserve Bank wanted to make credit supply to be less liberal, it announced in November 1951 that while it was willing to make advances against Government and other approved securities, it would not buy Government securities from the banks to help them tide over seasonal stringencies except when it was very necessary to do so. The intention was to force banks to seek accommodation through the discount window so that the new Bank rate (it has been raised to 3½% for the first time since the establishment of the Reserve Bank of India) could

become effective.[1]

While the consequence of this policy was to raise the current yield of Government bonds and, thereby, the long-term rate of interest from 3.02 and 3.03 in 1948 and 1949 respectively to 3.28 in 1951,[2] the dreaded collapse in the securities' market and the related lack of confidence in Government securities did not occur except for a very brief period. In 1952-53, the net receipts from public debt declined to Rs 24.01 crores from the level of Rs 58.19 crores which they had attained in 1951-52. However, since 1954-55, they have continued to show a rising trend even though there have, in the meanwhile, been three more increases in the Bank rate (one in 1957, another in 1963 and a third in 1964).

This shows that the argument that the raising of the Bank rate would affect Government's borrowing programmes by shaking people's confidence in Government securities was not very justified.

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1. Foreign Central Banking : The Instruments of Monetary Policy; Peter G. Fousek, pp. 41, 42.
2. U.N. Statistical Year Book, 1962.

Net Receipts of Public Debt and Current Yield of Government Bonds in India.

Year	Bond yields*	Net receipts of public debt during the year (rupees in crores)
1951-52	3.22	58.19
1952-53	3.69	24.01
1953-54	3.64	50.92
1954-55	3.65	344.53
1955-56	3.72	272.44
1956-57	3.92	364.54
1957-58	4.14	540.00
1958-59	4.18	747.46
1959-60	4.05	604.05
1960-61	4.06	712.96
1961-62	4.11	513.96
1962-63	4.36	896.88

* Figures relate to the calendar year(to the first of the two years mentioned).

Sources: (i) U.N. Statistical Year Books 1962, 1963.
(ii) 'Debt Expansion for India's Economic Growth', S.R. Sarma, Commerce Annual Number, 1963, P.A. 114.

Though since 1951, the Reserve Bank has not been committed to any pegging of security rates, it has generally avoided violent flustuations in gilt-edged prices.

Basically, the Reserve Bank's open market operations policy has been used more to assist the Government in its borrowing operations and to maintain orderly conditions in the Government securities market than for influencing the availability and cost

of credit. The objectives of what is called 'grooming' the market such as acquiring securities nearing maturity to facilitate redemption and to make available on tap a variety of loans to broaden the gilt-edged market have been more prominent in the conduct of open market operations in India.[3] An essential part of this conduct has been to help commercial banks tide over seasonal monetary stringency (usually in the period November - April) and to invest their surplus reserves in the slack season (usually May - October)[4] but open market operations 'has been rarely made use of deliberately for the purpose of restraining credit'.[5]

There is no doubt that, in certain situations, open market operations can be an effective method of regulating the flow of credit in an economy. But they require certain very familiar conditions to be fulfilled for their success.

In the first place, they require a broad and active capital market. It may not be enough to buy or sell just a few securities if the situation is too bad financially. The Central Bank cannot exert the influence it wants unless the market is such as to enable it to buy or sell securities in appropriate amounts.

In the second place, they require that the Central Bank, while reducing the reserve base of the commercial banks, does not allow easy access to the rediscount window, otherwise the gains from open market operations would be neutralised by easy borrowing from the Central Bank.

In the third place, it requires that the Central Bank is not committed to maintain Government security prices at any given level.

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3. Monetary Policy and Economic Growth, H.V.R. Iengar, p. 200.
4. Ibid.
5. Ibid.

For if that were to be so, the Central Bank would be afraid of acting on the reserves of the commercial banks for fear that the security prices might be disturbed.

The second condition need not present much difficulty. But the first one would because it relates to a certain institutional factor which is not easy to set right. It is possible that open market operations themselves help to widen the capital market but we evidently cannot go far with that, because, in the ultimate analysis, building up of a capital market can only result from economic development.

As for the third condition, the use of open market operations for supporting prices of Government securities is now less favoured than it was some time ago. India herself gave up bond support operations in November 1951 so that the commercial banks needing funds might be compelled to borrow from the Reserve Bank at the newly raised discount rate and thus make it effective.

The difficulties which prevent the use of open market operations in India, as an instrument of credit control, are obvious enough. But there is a paradox in the situation which is not so obvious. This paradox arises from the fact that floatation of loans and the consequent sale of securities are making for increased inflationary pressures in the economy whereas normally sale of securities should be deflationary. The reasons for this are the growing institutionalisation of our public debt, the change in its maturity pattern and the peculiar conditions of our economy which require funds, got through sale of securities, to be reinvested for economic development. In countries where supply of output is elastic, increase in inflationary pressures resulting from commer-

cial banks' participation in public debt, is likely to be neutralised by the increase in the output of consumers' goods which might be simultaneously taking place. In economies such as ours, this would not be so. Moreover, the change in the maturity pattern of the debt may not be so much in favour of short period loans that Government securities become a less rather than a more illiquid part of the assets portfolio. We shall see later that the maturity pattern of our public debt is changing in a manner so as to make for reduced illiquidity in the gilt-edged portfolio of our financial institutions.

The following table gives an idea of the ownership of the Funded Rupee Debt of the Government of India.

It can be seen from the table that the major owners of Funded Rupee Debt are not individuals but financial institutions.

One suspects that the institutionalisation of our public debt has not been altogether unintended. In the words of Shri H.V.R. Iengar, 'It has been the customary practice in India to issue Government loans during the earlier half of the slack season (generally in the quarter May - August), an important consequence of this being that the Reserve Bank has had to take up sometimes a rather large share of the initial issue of a Government loan for meeting the requirements of the investors during the rest of the year'.[6]

Apart from the fact that in the very process of acquiring those debts, commercial banks particularly, whose share in the ownership has been about ¼th of the total, add to the money supply, there is the problem of controlling the flow of Government securities emanating from financial institutions. Once such institutions choose to unload securities, the Central Bank might be led into the dilemma of either supporting long period rate of interest and pumping more money into the system or stabilising money supply and risking unpredictable rise in the long-period rate of interest. In the act of helping gilt-edged prices, the Reserve Bank not only increased its holding of marketable Government securities from Rs 158 crores in June 1948 to Rs 318 crores in March 1961, it added about 88 per cent to the money supply in the country at that time.[7] If we remember that 'Government debt in India has inevitably been about the same or greater than the money supply with the public,[8]

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6. Ibid.
7. Problems of Monetary Policy in an Under-developed Economy: J.D. Sethi, p. 210.
8. R.B.I. Bulletin, March, 1963, p. 325.

the prospect of this happening can only be worse, not better. Either way then, institutionalisation or public debt is likely to create problems for the economy.

Public Debt and Money Supply

(rupees in crores)

Year	National Income*		Money Supply**		Public Debt**		Public Debt National Income Ratio	Money Supply National Income Ratio	Money Supply Public Debt Ratio
	Amount	Index No. (base: 1951-52=100)	Amount	Index No. (base: 1951-52=100)	Amount	Index No. (base: 1951-52=100)			
1951-52	9970	100.0	1849.96	100.0	2619.69	100.0	26.3	18.6	70.6
1952-53	9820	98.5	1766.10	95.5	2643.70	100.9	26.9	18.0	66.8
1953-54	10480	105.1	1830.33	98.9	2694.62	102.9	25.7	17.5	67.9
1954-55	9610	96.4	1957.38	105.8	3039.15	116.0	31.6	20.4	64.4
1955-56	9980	100.1	2219.92	120.0	3311.59	126.4	33.2	22.2	67.0
1956-57	11310	113.4	2345.30	126.8	3676.13	140.3	32.5	20.7	63.8
1957-58	11390	114.2	2417.00	130.7	4216.13	160.9	37.0	21.2	57.3
1958-59	12600	126.4	2530.27	136.8	4963.59	189.5	39.4	20.1	51.0
1959-60	12950	129.9	2725.04	147.3	5567.64	212.5	43.0	21.1	48.9
1960-61	14160	142.4	2874.11	155.4	6280.60	239.7	44.2	20.2	45.8
1961-62	14630	146.7	3049.45	164.8	6793.94	259.3	54.6	20.8	44.9
1962-63	...	...	3315.14	179.2	7690.82	293.6	..	..	43.1

* = During the year; ** = At the end of the year.

Source: 'Debt Expansion for India's Economic Growth', S.R. Sarma, Commerce Annual Number,

There is no doubt that compared to the debt-income ratios of 144.0 per cent in United Kingdom, 70 per cent in U.S.A., 73.6 per cent in Australia and 80.1 per cent in Canada, our own debt income ratio (54.6 in 1961-62) is not very high. But we might recall here what an I.M.F. study had concluded some years ago: 'when the ownership distribution of Government debt is analysed, the countries of the world divide themselves into clear differentiated groups. In the first group are most of the relatively developed and industrial countries in all of which non-bank holdings of Government debt constitute a large part of the total Government debt and in all of which the total Government debt is large when compared to the country's money supply. In the second group are the relatively under-developed and raw material producing countries in all of which the banking system holds a large part - in some cases almost all - of the Government debt and in all of which the total debt is small compared to the country's money supply.[9]

Continuing the same theme, another study[10] suggested that 'in the financially less developed countries, non-bank sectors tend to hold only a small part of their assets in liquid form and these principally in monetary form. Thus the market for financial assets is limited and Governments finance themselves principally by recourse to the banking system. For these countries, the holdings of Government debt by the non-bank sectors are a small part of the total outstanding debt. In the financially more developed countries,

9. <u>International Financial Statistics</u>, August 1952, pp. (ii), (iii).
10. Ownership Distribution of Government Debt: <u>International Financial Statistics</u>, October, 1952.

the non-bank sectors tend to hold a relatively large part of their assets in liquid form and a significant part of their liquid assets in the form of financial claims on others. Hence Governments have been able to finance themselves largely from savings of the non-bank investors and have been able to increase their debt without recourse to the banking system'.

This being so, it may not be entirely desirable for under-developed countries like our own to approximate the debt-income or the debt-money supply ratio of developed countries. Any attempt at such approximation is likely to be inflationary since the participation of institutional investors in Government debt is far larger than in developed countries.

The scheduled banks' investments in gilt-edged securities in India has risen considerably during the last 10 years. The index of investments rose from 100 in 1951 to 256.4 at the end of 1959 and 189.8 at the end of 1961. As against this, the index of their investment in industrial securities rose from 100 in 1951 to 187 at the end of 1959 and 147.9 at the end of 1961. The investments in Government securities during the period accounted for more than 90 per cent of the total investment except in 1961, whereas the share of industrial securities was, on an average, only 2.8 per cent of the total investments.[11] In fact up to 1958, the rate of

11. To their Government securities portfolio, the main component of their liquid assets, banks added Rs 130 crores (or 24.3 per cent) during 1963 as compared to Rs 98 crores (or 22.3 per cent) during 1962. At the year end of 1963, the ratio of investments in Government securities to deposits stood at 30.1 per cent - a level which was 2.3 percentage points higher than at the end of 1962 - R.B.I. Bulletin, April 1964, p. 465.

investment in industrial securities indicated a decline, the average rate of decline (based on mean deviation) being 0.32 per cent. Since 1958, there has been some improvement in the situation but despite that improvement, investments in Government securities continue to dominate. Of course, the scheduled as well as the non-scheduled banks' industrial advances rose from 32.5 per cent of total advances in 1951 to 53.5 per cent in 1961 showing a high increase of 65 per cent.[12] But this makes no difference to the point made earlier, namely, that commercial banks are more interested in supplying long-term finance to the Government rather than to the private sector. And since, this is not the same thing as a public debt policy mobilising savings of the 'people', it is not a happy development.

Increased possession of Government Securities by commercial banks and other financial institutions increases their liquidity and poses an inflationary threat which cannot be ignored. In its own way, the 1963-64 Report of the Central Board of Directors of the Reserve Bank of India refers to this factor.[13] "Government indebtedness to the banking system, comprising investment in Government securities by the Reserve Bank and other banks (excluding investments of P.L. 480 and P.L. 665 funds) and ways and means advances adjusted for Government's cash balances with the Bank, continued as in the preceding two years, to be the dominant expansionary factor....."[14] Referring to the rising price spiral of 1963-64, the Report says: "Viewed from the purely monetary angle,

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12. 'Investing Bank Funds in New Capital Issues', K.N. Upadhyaya, Supplement to 'Capital' of 19th December 1963, p. 151.
13. Reserve Bank of India Bulletin, August 1964, p. 1021.
14. op. cit., p. 1016.

an important factor contributing to the deterioration in prices was the rapid increase in liquidity......"[15]

Usually increase in banks' holdings of Government securities is supposed to lower rather than increase their liquidity. We remember that way back in the year 1948, the Reserve Bank had to issue a directive advising commercial banks to redistribute their securities portfolio so as to reduce the proportion of long-term Government securities. The Bank was afraid lest preponderance of long-term securities might adversely affect the liquidity of the banking institutions. But the change in the maturity pattern of our public debt which has been discernible of late should tend to reduce the illiquidity attached to the Government securities now.

15. op. cit., p. 1015.

Maturity pattern of the Government of India Rupee Loans

(crores of rupees)

End of March	Undated	Percentage to total	Over 10 years	Percentage to total	Between 5 and 10 years	Percentage to total	Under 5 years	Percentage to total	Total
1951	257.85	17.9	519.33	36.1	342.51	23.8	318.77	22.2	1438.46
1956	257.85	17.1	241.77	16.0	616.52	40.9	393.13	26.1	1508.67
1961	257.85	10.9	690.45	26.9	756.41	29.4	866.62	33.7	2571.33
1962	257.84	9.6	806.43	30.0	698.96	26.0	925.21	34.4	2688.45
1963	257.84	9.1	869.67	30.6	711.51	25.0	1001.91	35.3	2840.94
1964	257.84	8.3	558.45	17.9	1245.28	40.0	1052.34	33.8	3113.92

Source: Report on Currency and Finance for the year 1963-64, p. S 96.

A glance at this table would indicate that since 1951, the maturity pattern of rupee loans has been changing in favour of loans for shorter durations. The undated securities which were 17.9 per cent of the total in 1951 are only 8.3 per cent in 1964. Even dated loans of more than 10 years duration are only 17.9 per cent in 1964 as against 36.1 per cent in 1951. Loans for a period between 5 and 10 years and those for a period under 5 years have constituted a rising percentage of the total, the former rising from 23.8 per cent in 1951 to 40 per cent in 1964 and the latter from [illegible] per cent in 1951 to 33.8 per cent in 1964.

What is the position of the liquidity requirements for our commercial banks? Formerly section 24 of the Banking Companies Act required every banking company to hold in cash (including vault cash and balances with the Reserve Bank or any notified bank whether as part of cash reserve or not), gold or unencumbered approved securities aggregating to at least 20 per cent of its total liabilities. Since then this section has been amended (it was amended in September 1962). According to the amendment, the reserve required with effect from 16th September 1964 would be 25 per cent of total deposits and will not include the cash reserve prescribed under section 42 of the Reserve Bank of India Act or Section 18 of the Banking Companies Act. (The deposit held by a foreign banking company with the Reserve Bank under Section 11 of the Banking Companies Act will, however, continue to be treated as part of the reserve under Section 24). Including the 3 per cent statutory cash reserves, the minimum ratio of liquid assets required to be maintained by all banks operating in India would be 28 per cent.

However, in view of the change in reserve requirements

introduced in September 1962 whereby the Reserve Bank would have the power to raise cash reserve requirements to 15 per cent of demand and time liabilities in place of the earlier maximum of 8 per cent for time and 20 per cent for demand liabilities, overall liquidity ratio of scheduled banks can be raised to a maximum of 40 per cent. In respect of the non-scheduled banks, this ratio will remain fixed at 28 per cent.[16]

A glance at the following table will show that the liquidity ratio for all scheduled banks (excluding the State Bank) has been higher than 28 per cent.

Liquid Assets of Scheduled Banks*

(In crores of rupees)

As on the last Friday of	Total demand and time liabilities	Cash in hand and balances with the Reserve Bank of India	Unencumbered Approved Securities	Other Liquid Assets	Total Liquid Assets	Liquidity Ratio (Ratio of 6 to 2)
1	2	3	4	5	6	7
1960	1307.7	112.1	308.1	20.3	440.6	33.7
1961	1509.1	114.5	379.6	23.6	517.7	34.3
1962	1680.8	109.4	430.5	19.7	559.5	33.3

* Figures are based on Form X and are exclusive of the State Bank of India.

Source: Trend and Progress of Banking in India during the year 1962, p. 20.

Thus even the new higher liquidity ratio which came into force in September 1964 might not be able to mop up the excess liquidity which is being generated through public debt operations.

16. Report on Currency and Finance for 1962-63, p. 46.

Our scheduled banks have, of late, been showing great interest in Treasury Bills. During 1963, gross sales of Central Government Treasury Bills, including intermediates, aggregated at Rs 220 crores (excludes sales in favour of the Reserve Bank of India) as compared to Rs 163 crores during 1962, and the share of banks other than the State Bank and its subsidiaries in total gross sales of Treasury Bills (including intermediates) rose from 28 per cent in 1962 to 52 per cent in 1963.

Maturity-wise Investments in Government Securities of Indian Offices of Scheduled Banks

(In crores of rupees)

No. of Reporting Banks	March 31, 1960 91		March 31, 1961 85		March 31, 1962 81	
	Amount	Percentage to total	Amount	Percentage to total	Amount	Percentage to total
I Treasury Bills	49.1	6.7	28.1	4.8	71.2	11.4
II Securities Maturing*						
1. Below 5 years	258.7	35.0	256.8	44.3	228.8	36.7
2. Between 5 and 10 years	310.5	42.1	213.5	36.8	242.4	38.8
3. Between 10 and 15 years	86.4	11.7	62.8	10.8	62.3	10.0
4. Over 15 years	33.2	4.5	19.2	3.3	19.7	3.1
Total of I and II	737.9	100.0	580.4	100.0	624.4	100.0

* Face Value.

Source: Trend and Progress of Banking, 1962, p. 21.

Whereas on March 31, 1960, and March 31, 1961, Treasury Bills with the scheduled banks constituted only 6.7 per cent and 4.8 per cent respectively of their total investments in Government

securities, on March 31, 1962 they constituted 11.4 per cent. However, this may be due to the fact that while on the one side the demand for credit has been rising rapidly, on the other, the cash-deposit ratio is being allowed to fall. The cash-ratio dropped from 8.5 per cent at the end of 1961 to 6.5 per cent at the end of 1962, touching a low point of 5.7 per cent in the last week of November 1962. During 1963, the cash ratio declined further reflecting mainly the larger accretion to deposits in 1963 than in the previous years.

The increased holding of Treasury Bills has not, however, made much difference to the scheduled banks' interest in long-term Government securities. Their investment in such securities maturing between 5 and 10 years actually rose from 36.8 per cent of their total investment in Government securities on March 31, 1961 to 38.8 per cent on March 31, 1962.

The Reserve Bank's study of ownership of marketable Government securities mentioned earlier takes satisfaction from the fact that 'on the whole, the trend of the ownership pattern of the marketable debt in India has been towards a more even distribution over the different investor groups, bank as well as non-bank, which correspondingly improves the efficacy and scope of monetary policy since thereby the changes in capital value affect the asset portfolios of more numerous groups of investors and percolate more easily over the entire economy than if ownership were concentrated in fewer groups as in the pre-war years in India which is also an important reason for the absence of an effective monetary policy in that period'.[17] However, the study agrees that 'this reveals a possible

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17. R.B.I. Bulletin, March, 1963, p. 325.

source of conflict between the relative needs of monetary policy which necessitates an even distribution of debt ownership and of debt policy which requires a greater placement of debt with the non-bank investors if the debt is to be firmly held'.[18] Once it is recognised that public borrowing in an under-developed country has purposes different from those which public borrowing in a developed competitive economy may have, the even distribution of public debt should not be a cause for satisfaction. The primary purpose should be to reduce the proportion of institutionalised public debt as much as possible. In an over-populated capital scarce country such as ours, public borrowing should enable the <u>people</u> and not the banks to save. For while the banks do not release any real resources when they save in a Government loan, the people may.

It seems then that India's public debt policy has not been as non-inflationary as a public debt policy helping to supplement tax revenues and serving to avoid creation of money, should be. Unless methods are discovered whereby there is a much larger non-institutional participation in public debt than hitherto, it will be difficult to regard this policy as making for growth with stability which is our accepted economic objective.

Referring to the complaints and difficulties of raising funds for the capital market, Shri T.T. Krishnamachari, India's Finance Minister, is reported to have said in Parliament on 17th September 1964 that 'Industries are to learn to tap energetically the savings of the people. It was primarily the duty of the industries to cultivate the market to meet their requirements so that eventually the market also responded to the needs of industries'.[19] Perhaps, what

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18. Ibid.
19. <u>The Leader</u>, September 18, 1964.

is sauce for the goose is not sauce for the gander. However, for savings mobilisation in under-developed countries, we may have no choice but to think in terms of the same sauce for both.

Will higher interest rates following abandonment of cheap money policy induce higher non-institutional participation in our public debt? It is difficult to answer this question categorically either way but the following figures show that we can be hopeful:

Small Savings Collections (net)

(Lakhs of rupees)

Year	Bank rate	Small Savings
1962-63	4-4½	7495
1963-64	4½	12630

Source: Report on Currency and Finance, 1963-64, p. 83.

According to the Report (for the year July 1 1963 - June 30, 196 of the Central Board of Directors of the Reserve Bank of India, one of the factors behind the rise in small savings is a higher rate of interest than formerly.[20]

The controversy regarding whether savings are or are not interest elastic is too old and stale to be taken up here. But where a rise in income is conditional upon a rise in real savings, we may have no choice but to trust that savings will be interest elastic. To the extent to which they are not, savings mobilisation will, of course, require a greater dependence upon taxation than upon monetary policy, but how does this establish that interest inducement is not worth experimenting with specially when a number

20. R.B.I. Bulletin, August, 1964, p. 1014.

of other vital considerations (already mentioned) also suggest that interest rates should be upgraded?

A genuine argument against upgrading of interest rates in India is that this would increase the cost of public debt whose volume has been rising so rapidly all these years.

The index of outstanding public debt rose from 100 in 1951-52 to 126.4 in 1955-56. The very next year, it rose to 140.3 and in 1958-59 it was 189.5. Two years later it became 239.7 and in 1962-63 it had reached the level of 293.6.[21] According to one calculation, if the interest rate on Government loans stabilised at 10 per cent, which is almost twice the rate which is current, the eventual cost of replacing Central Government terminable loans (maturing before the end of 1979) of the order they were at the end of March, 1959 (Rs 1,923.12 crores) would rise from Rs 65.42 crores to around Rs 192.31 crores.[22] On terminable debt of State Governments maturing by 1971 (Rs 288.19 crores), the cost, at 10 per cent interest rates, would rise from Rs 11.25 crores to about Rs 29 crores.[23]

As has already been mentioned, the public debt of the Government - both Central and States - has been continuously rising. The position in respect of the last 4 years can be seen from the following tables:

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21. Debt Expansion for India's Economic Growth: S.R. Sarna, Commerce Annual Number, 1963, p. A. 114.
22. Interest Rate Policy: P.B.M., The Economic Weekly, November 14, 1959.
23. Ibid.

Rupee Debt of the Government of India

(Crores of rupees)

	End March			
	1961	1962	1963	1964
Rupee loans	2571	2688	2841	3114
Treasury bills	1106	1175	1300	1382
Small Savings	975	1061	1136	1252
Other obligations*	826	931	1036	1155
Total	5478	5856	6316	6902

* Investments of P.L. 480 Funds, Service Funds, State Provident Funds, Deposits of Depreciation, Development and Reserve Funds, etc., and Compulsory Deposits.

Source: Report on Currency and Finance for the year 1963-64, p. 80.

Debt Position of States

(Crores of rupees)

	End of March			
	1961	1962	1963	1964
Permanent debt	493	570	654	645
Floating debt	42	50	25	40
Loans from the Central Government	2016	2314	2677	3156
Other debt	52	64	77	97
Unfunded debt	135	150	164	183
Total	2737	3148	3597	4122

Source: Report on Currency and Finance for the year 1963-64, p. 85.

Thus a raising of interest rates would make public debt in India a far more costly proposition than it has thus far been. Part of this cost would be met of itself since as higher interest

rates raised incomes of the lenders, revenue receipts from taxes would be commensurately higher. Therefore, a portion of increased interest cost would be self-financed. If the gross rate of interest on Government securities goes up from 4 per cent to 10 per cent, the net rate to the Government, assuming an income-tax liability on such income at 50 per cent would rise from 2 to 5 per cent (that is by 3 per cent).[24]

However, even then, public borrowing would be costlier than hitherto. And this would compel either increased taxes or increased prices of the goods whose production is financed through public borrowing. Public enterprises like the Railways may have to increase their service charges. Commercial undertakings may have to increase the prices of goods they are supplying to the general public. But the calculus would not be complete unless against this disadvantage which, in a sense, would be related to our past sin of having encouraged a higher degree of capital-intensity in public enterprises, we placed such advantages as development with stability, reduced distortions in investment, increased employment, no arbitrary re-distribution of income, reduced leakages in conspicuous consumption etc.

Moreover, the very fact of costlier debt financing may compel the Government to cut out unnecessary expenditure and to encourage serious rethinking on its fiscal policy so that the tax weapon could be wielded more boldly than before. We have to accept that on both these matters, we have not felt as much concerned as we should.

Take, for instance, our fiscal policy of all these years. For the Third Plan, while we were proposing to pull up national

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24. Interest Rate Policy by P.B.M., Economic Weekly, November 14, 1959.

income at the rate of 5 per cent per annum or above, we did not expect savings to rise by more than one per cent of our national income annually. It means that a good part of the rise in our national income was intended to go to consumption and this was much more than was necessary to absorb anticipated additions of population at constant standards of living per capita. If it is a fact that it is the failure of our fiscal policy to mop up a higher proportion of increases to our national income, which has tempted us into easy finance, then dearer money can very well force us to think seriously about reorientating our fiscal policy. This by itself will be a tremendous gain.

CHAPTER 12

CONTROL THROUGH VARIABLE RESERVE REQUIREMENTS

The limitations of the open market operations policy, particularly in those under-developed countries which have a liberal money policy approach and whose public debt policy is inflationary, point to the technique of variable reserve requirements as the alternative method of controlling credit quantitatively.

The technique is now quite popular in many countries. According to one assessment, 'By 1957, only ten countries appear to have kept their reserve ratios unchanged since their establishment. While a number of those countries which have made changes have done so only once or twice, the requirements have been varied more frequently in Australia, Bolivia, Colombia, Ecuador, West Germany, Korea, the Netherlands, New Zealand and Peru'.[1]

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1. <u>Foreign Central Banking the Instruments of Monetary Policy</u>, Peter G. Fousek, p. 50.

Changes in Reserve Requirements in Selected Countries
(Through October, 1957)

Country	Number of changes in reserve ratios	Variability established in
Australia	a	1941
Bolivia	8	1945
Colombia	27	1949
Ecuador	10	1937
West Germany	10	1948
Korea	8	1950
Netherlands	12	1954
Newzealand	23	1936
Peru	15	1948

a The Australian requirements - based upon the so-called 'special account' system, which is a variety of the usual cash-reserve requirements - are adjusted frequently but are not given in terms of ratios.

Source: Foreign Central Banking, the Instruments of Monetary Policy: Peter G. Fousek, p. 50.

Up to 1956, the Reserve Bank of India had no power to vary reserve requirements. The cash-reserves which the scheduled banks were supposed to maintain were to be 5 per cent of their demand and 2 per cent of their time liabilities. However, an amendment to the Reserve Bank of India Act, which came into force in October, 1956, gave the Bank power to vary the minimum reserve requirements of scheduled banks between 5 and 20 per cent in the case of demand liabilities and between 2 and 8 per cent in the case of time liabilities. Subject to these maxima, the Bank could also require a 100 per cent reserve on the increase in deposits

after a specified data.[2] A special feature of the new power was that the Reserve Bank could impound additional reserves computed in respect of the excess of demand and time liabilities over the level of such liabilities on a base date, provided that the total reserves so maintained did not exceed 20 per cent of their demand and 8 per cent of their time liabilities.[3]

The technique of varying the reserve requirements also has its difficulties.

First, it assumes that the commercial banks expand deposits by reference to a fixed ratio so that if it is raised, the deposits will be commensurately affected. However, the truth of the matter is that commercial banks operate on the basis of a range of ratios which is not quite easy to control. As is obvious, the existence of a range of ratios introduces greater elasticity in the supply of deposits than might be desired in the interests of control.

Secondly, in under-developed countries, the changes in deposits on account of the seasonal nature of agricultural operations which predominate and the fluctuating character of foreign trade, may require frequent changes in the cash-deposit ratio.

Thirdly, since under-developed areas do not have branch but unit banking and there is a great difference between the status of the small and the big banks, changes in minimum reserve ratios might not be equally fair to all the banks in the economy.

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2. Central Banking in South and East Asia, edited by Gethyn Davies, p. 39.
3. 'The Role of the Reserve Bank in the Planned Economy', lectures by Shri H.V.R. Iengar under the auspices of the National Bank of Egypt, Cairo, November, 1960.

Even so, this weapon has better chances of being effective than open market operations, because it is less roundabout and can be wielded with the backing of a statutory authority. Provision for penalty can be made if a bank avoids the minimum ratio. The danger that commercial banks might run off their securities to replenish reserves above the prescribed minimum with a view to expanding deposits has also now diminished because of the increasing reluctance of the Central banks to support security prices. If commercial banks insist upon unloading government securities, they run the risk of capital depreciation which they may not like.

For about four years since the conferment of the new powers, the Reserve Bank did not use the weapon of variable reserve requirements to control credit in the Indian economy. But when in 1959-60, prices began to rise despite improvement in production, the stock exchange exhibited an unhealthy boom and the liquidity of the banking system increased, the new powers relating to variable reserve requirements were used seriously for the first time. In March, 1960, all scheduled banks were required to maintain with the Reserve Bank, in the form of additional deposits, 25 per cent of any additions to the demand and time liabilities after March 11, 1960, over and above the deposits hitherto required (viz., 5 per cent of demand and 2 per cent of time liabilities). Since these reserve requirements were announced in the busy season, they were on the low side but as the slack season with its usual excess liquidity approached, they were raised further. Thus in May, banks were required to maintain with the Reserve Bank additional reserves of (1) 25 per cent of the amount by which their total liabilities on May 6, 1960 exceeded the level as of March 11, 1960 and (2) 50

per cent of the increase in total liabilities since May, 1960.[4]

With a view to avoiding losses to the banks, the Reserve Bank agreed to pay interest on the additional reserves for each half year, at the average rate of interest paid for the half year by the scheduled bank concerned on its total deposits. Subsequently, this was enhanced to one-half of one per cent over the average rate of each bank in order to provide adequate stimulus to deposit expansion consistently with the need of credit policy.[5]

The total of cash in hand and balances of scheduled banks with the Reserve Bank which stood at Rs 113.9 crores at the end of December, 1959 rose to Rs 139.7 crores in April, 1960, raising the cash-ratio from 6.4 per cent to 7.5 per cent. Subsequently, there was a rise both in the level of cash reserves of banks and their cash-ratio, after the issue of the Bank's directive dated May 5, 1960. Cash reserves and the cash-ratio of scheduled banks stood at Rs 162.6 crores and 8.6 per cent respectively in July, 1960, as compared with Rs 116.4 crores and 6.8 per cent respectively in July, 1959. The fall witnessed in the level of deposits since August had its impact on the cash reserves and, therefore, on the cash-ratio of scheduled banks. Thus cash reserves of scheduled banks declined to Rs 136.5 crores at the end of November, 1960; consequently the cash-ratio also came down to 7.5 per cent. The reserves and the cash-ratio stood at Rs 119.6 crores and 6.7 per cent respectively at the end of November, 1959.[6] From November 11, the further impounding of additional deposits was suspended. Besides, the

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4. Monetary Policy and Economic Growth: H.V.R. Iengar, p. 197.
5. Ibid.
6. Trend and Progress of Banking, 1960.

amount of additional reserves required was reduced from 50 per cent to 25 per cent of the increase: the latter proportion was to apply to increase in liabilities since March 11, 1960. In December, 1960, the reserves appeared to have resumed their upward trend and stood at Rs 162 crores; the cash-ratio stood higher at 9 per cent.[7] With effect from January 13, 1961, the additional reserve requirements were, therefore, altogether abolished.

In 1962, the Reserve Bank of India Act was amended under which the reserve requirements were fixed at 3 per cent of aggregate demand and time liabilities with effect from September 15, 1962 in place of 5 per cent of demand and 2 per cent of time liabilities in force till then. This meant, in effect, a lowering of the reserve requirements from an average of 3.25 per cent to 3 per cent.[8] This also meant that the Reserve Bank did not consider it desirable to make any distinction between demand and time deposits so far as prescribing reserve requirements was concerned. In September, 1962, the maximum of the cash-reserve ratios was also changed to 15 per cent of total liabilities whereas the 1956 amendment, which was now being superseded, had provided for a maximum of 8 per cent for time and 20 per cent for demand liabilities.

Non-scheduled banks were brought in line with scheduled banks, (except in regard to variation in cash-reserves) so as to require them to maintain with themselves or in current account with the Bank or its agencies, cash or balances to the extent of 3 per cent of their liabilities.

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7. Ibid.
8. Trend and Progress of Banking in India during the year 1962, p. 21.

We have referred to the requirement of a new liquidity ratio, viz., 28 per cent for banks with effect from September, 1964. In view of the powers of the Reserve Bank to vary cash requirements up to a maximum 15 per cent, the over all liquidity ratio for the scheduled banks may be raised to a maximum of 40 per cent whereas in the case of non-scheduled banks, it would remain fixed at 28 per cent.[9]

The effect of the amendment relating to reserve requirements and liquidity ratio is to split up the over all liquidity requirements of scheduled banks into (i) statutory balances maintained with the Reserve Bank and (ii) other liquid assets including unencumbered approved securities. This segregation was considered necessary to minimise the impact, on security holdings of banks, of any action to raise the reserve requirements intended to restrict bank credit by ensuring that with any increase in reserve requirements, the overall liquidity requirement was also correspondingly raised.[10]

Thus the changes in reserve requirements introduced in September, 1962 were not meant to control credit immediately but to rationalise credit control arrangements in respect of cash and liqudity ratios of the banks so that, at the time of need, credit control could be wielded more effectively. This means, in effect,

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9. Report of Currency & Finance, 1962-63.
10. The overall minimum liquidity ratio of 28 per cent would be made up of 3 per cent of cash reserves and 25 per cent of other liquid assets. With the ratio of other liquid assets to the total of demand and time liabilities remaining the same, a rise in the ratio of cash reserves (up to a maximum of 15 per cent) would automatically raise the over all liquidity ratio.

that since 1956 when the Reserve bank thought of the technique of variable reserve requirements for the first time, it has never been seriously used except once or twice in 1960. There is only the hope that it would be used more effectively in the future.

Even in 1960, the impact of additional reserve requirements of 25 per cent of the increase in scheduled bank deposits since March 11 which were later raised to 50 per cent with effect from May 6, was sufficiently neutralised by recourse to Reserve Bank increased by Rs 50 crores, as compared to Rs 1 crore only in 1959. The weekly average of the outstanding borrowing during the year was also much higher at Rs 38.4 crores, as compared to Rs 18.5 crores in 1959. During the last four months of the busy season 1959-60 (January to April, 1960), average outstanding borrowing at Rs 44 crores was higher than in the corresponding period of 1958-59 (Rs 39 crores). The absence of the normal slack season contraction in bank credit during the year led to smaller repayments by the banks. During the period May - October, which conventionally, is considered as the slack season, the average outstanding borrowing from the Reserve Bank remained much higher at Rs 38 crores than Rs 10 crores in the corresponding period of 1959.

The Reserve Bank attempted to arrest the deterioration by introducing a system of quotas and penal rates but the Bank rate itself remained unchanged because, perhaps, the Bank did not think there was reason to depart from the general attitude of cheap money.

Apart from the fact that in India we have tried to avoid

11. Monetary Policy and Economic Growth: H.V.R. Iengar, p. 197.

using the technique of variable reserve requirements frequently our reserve requirements, as compared to those of even some developed countries, are quite low.

In the United States of America, the range of variations in the reserve-ratios is between 10 per cent and 22 per cent of demand deposits for country banks while the range for time deposits is between 3 per cent and 6 per cent for all member banks.

Actually the convention of varying the reserve-ratios is now growing around a classification of reserves into three categories, primary reserves, secondary reserves and tertiary reserves. A primary reserve of between 5 per cent and 10 per cent of deposits, a secondary reserve of between 10 per cent and 20 per cent of deposits and a tertiary reserve of about 30 per cent of deposits are generally regarded as adequate. The idea is to grade reserves in terms of their potentiality to be liquid. Secondary and tertiary reserves are intended to be capable of conversion into liquid form when the necessity arises.

Since 1st September, 1962, the cash-reserve requirements in U.S.A. are 16½ per cent of the net demand deposits for the reserve city banks and 12 per cent of net demand deposits for the country banks plus 5 per cent of time deposits for the banks in either category.

The U.S. banks regard U.S. securities having a maturity of three years or less, commercial paper, bankers' acceptances and loans to stock exchange firms as constituting a secondary reserve which varies for individual banks between 12 per cent and 25 per cent of demand deposits and between 8 per cent and 12 per cent of time deposits.

They have no statutory provision in regard to reserve-ratios in United Kingdom but as a matter of convention, banks hold cash and balances with the Bank of England to the extent of 8 per cent of total deposits. Banks also hold liquid assets (comprising cash, balances with the Bank of England, money at call, treasury bills and commercial bills) to the extent of 30 per cent (or over) of total deposits. While it may be that cash reserves sometimes fall below 8 per cent, the ratio of liquid assets is always above 30 per cent of the total deposits.[12]

It is not being suggested that provided the cash-deposit ratio is higher, credit creating capacity of the banks would be necessarily restricted.

For there is another ratio also which is important. This is the proportion which cash with the commercial banks constitutes of their total reserves or liquid assets. Let us assume that the statutory or conventional cash ratio on all deposits is 8% and that a certain commercial bank gets additional cash (because some-one is, let us say, putting some of his cash balances in the form of time deposits with the bank) on account of which the proportion of cash to the bank's liquid reserves rises. The earlier proportion was one fifth and now, we might suppose, it is two fifth. If to start with, the commercial bank in question had liquid reserves worth 100, the amount of cash with the bank should rise from 20 to 40. Since the cash deposit ratio is the same, the deposits now can be hundred per cent higher than before. Thus given the reserve ratio or cash deposit ratio, the higher the

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12. 'Credit Demand Rising Faster than Bank Reserves', R.N. Mitra, Capital Annual, 1963.

proportion which cash constitutes of the total liquid reserves of a bank, the greater the amount of money which that bank can create.

We can argue out for reserve-ratio in the same manner though a rise in the reserve ratio will have an effect upon credit creation opposite to that produced by a rise in the ratio of cash to the total liquid reserves of a bank. A rise in the reserve-ratio will, as is well known, tend to reduce a bank's credit creating capacity. But this will happen only when the ratio of cash to the bank's total liquid reserves remains the same. If both the ratios are variable, the net effect will be found out by summing up the two effects together. If, for example, the ratio of cash to total liquid reserves is rising and the reserve ratio is rising too, from the inflationary impact on credit creation of the former, we will have to allow for the deflationary impact of the latter in order to be able to form a right picture of the net amount of money which a bank would have ultimately created. More concretely, suppose the net addition to the liquid reserves of the banking system is ΔC. Suppose also that the ratio of cash to total liquid resources which is being observed is $\frac{C_r}{L_r}$. Then the additional amount of cash which the banking system should have would be $\Delta C \frac{C_r}{L_r}$.

If the cash-deposit ratio which the banks are required to observe is K, and the amount of additional deposit which banks can create is ΔD

$$\Delta D = \frac{1}{K} \left(\Delta C \frac{C_r}{L_r} \right)$$

Thus a rise in the proportion of cash to liquid reserves raises

the value of ΔD, the additional deposits possible, whereas a rise in K, the cash-deposit ratio tends to lower that value. In situations where $\frac{Cr}{Lr}$ is rising and K is falling, ΔD would be under a double pressure to rise.

We might recall here, however, a limitation we had referred to while considering whether the technique of variable reserve requirements could really be as effective as was made out. We had said there that provided the banks observed a range of ratios, the technique may not produce the desired effect. For, a range would often leave them with a margin over statutory requirements for manoeuvring unless the statutory requirements are set at the maximum of the range itself. Whatever is true of the cash-deposit ratio would be true of the cash-total liquid assets ratio as well. As long as there is a margin of excess over statutory requirements in respect of any or both of these ratios, the banks can put it to use at the time they like.[13]

In India, the banks enjoy a margin in respect of both these ratios.

Cash-deposit, Cash-Total Liquid Assets Ratios of Scheduled Banks In India*

Year	Cash-Deposit Ratio	Cash-Total Liquid Assets Ratio	Total Demand & Time Liabilities
1960	8.6	25.4	1307.7
1961	7.6	22.1	1509.1
1962	6.5	19.6	1680.8
1963	6.3	-	-

* Exclusive of the State of India.
Source: (i) Trend & Progress of Banking in India, 1962.
(ii) Reserve Bank of India Bulletin, April, 1964.

13. As long as excess reserves exist, the expansion in deposits would depend more upon the will of the banks and less upon statutory ratios. Only when the actual and the statutory ratios are equal to start with, with a decline in the ratio of cash to liquid reserves or an increase in the ratio of cash to deposits will be deflationary.

Till September, 1962, the average reserve requirement against both the demand and time liabilities put together was 3.25 per cent,[14] but the actual cash-deposit ratio of the scheduled banks was 8.6 per cent in 1960, 7.6 per cent in 1961 and 6.5 per cent in 1962. The banks had throughout more than 3 per cent margin in their cash-deposit ratio to manoeuvre. Since September 1962, the reserve requirement has been lowered to 3 per cent,[15] and even though the actual cash-deposit ratio of the banks is declining in comparison to the earlier years, more than 3 per cent margin still continues to remain.[16]

The position in regard to the cash-liquid reserves ratio is even worse. The Banking Companies (Amendment) Act, 1962 requires all banks to maintain with effect from September, 1964, an overall minimum liquidity ratio of 28 per cent of which 3 per cent will be the cash reserves against the aggregate demand and time liabilities. This means that the statutory ratio of cash to total liquid reserves would be about 10.7 per cent. This is far less than the actual ratio of cash to total liquid reserves the banks have been having during the past few years. For example, in 1962 this ratio was 19.7 per cent while in 1961 it was 22.1 per cent. In 1960, it was as high as 25.4 per cent. Over the statutory ratio in 1962,

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14. Trend and Progress of Banking, 1962.
15. Ibid.
16. As a result of the change, the Scheduled banks' statutory minimum balances with the Reserve Bank were reduced to Rs 65.8 crores during the week ended September 21, 1962, thus freeing about Rs 6 crores of their cash-reserves for deposit creation.

cash reserves still leave a margin or excess of 9 per cent with which to manoeuvre, so far as the cash-liquid reserves requirement is concerned. That is why, despite the fact that over the years the ratio of cash to liquid reserves has been declining, the aggregate deposits of commercial banks have been rising. The tendency has been reinforced by the decline in the cash-deposit ratio.

Deposits of Scheduled Banks

(In crores of rupees)

Years	Demand Deposits (excluding inter-bank deposits)	Time deposits (excluding inter bank deposits)	Aggregate deposits (excluding P.L. 480/665 funds)
1960	721.0	1086.4	1577.2
1961	732.6	1102.1	1696.5
1962	816.9	1222.0	1929.3
1963	997.2	1255.6	2212.4

Source : R.B.I. Bulletin, April, 1964, p. 462.

During 1960, deposits rose at the average annual rate of 6.9% but during 1961, the rate of rise was 11.0 per cent. In 1962. the annual average rate of growth of scheduled banks' deposits was higher and stood at 13.7 per cent. During 1963, the rising trend continued and the rate of growth deposit stood even higher at 14.7 per cent. The rate of rise of the inflationary component of deposits, namely, demand deposits was also very rapid particularly during the last year. During 1960, demand deposits rose at the rate of 7.8 per cent per annum and after a slight decline in 1961 (6.9 per cent per annum) they began to rise at the rate of 11.5 per cent per annum during 1962. The

rate at which demand deposits rose during 1963 was higher than that of any of the immediately preceding years - about 23.3 per cent per annum.[17]

Statutory requirements apart, banks may like to observe cash-deposit, cash-liquid reserve ratios of their own in the interest of retaining the depositors' confidence. But in so far as developments tend to increase the depositors' confidence in the banks, they may use excess cash and liquidity for expanding their deposits in an even greater measure. We have had such developments in India recently.

One such development has been the establishment of the Deposit Insurance Corporation on January 1, 1962. This Corporation is an autonomous statutory body intended to give a measure of protection to depositors to a specified extent (at present fixed at Rs 1500/- per depositor) from the risk of loss in the event of a bank's failure. The Corporation has fixed the rate of premium to be paid by insured banks at 5 paisa per annum for every 100/- of their total deposits. The maximum premium permissible under the relevant Act is 15 paisa per Rs 100/- of deposits.

As on the last Friday of September, 1963, the total number of deposit accounts with insured banks was 85.9 lakhs, of which 66.5 lakhs or 77.5 per cent comprising balances not exceeding Rs 1500, were fully insured by the Corporation.

Another development tending to increase the depositors' confidence has been the Banking Companies (Second Amendment) Act

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17. The figures are from Trend and Progress of Banking in India during 1962 and the R.B.I. Bulletin, April, 1964.

1960, which is meant to facilitate expeditious payment to the depositors of banks in liquidation and also to vest the government and the Reserve Bank with additional powers to rehabilitate banks in difficulties. The Act was brought into force on September 19, 1960. Prior to the Amendment, the procedure for determination of claims of secured creditors and other persons entitled to preferential treatment was mainly responsible for a good deal of delay in payment to depositors of banks in liquidation.

Upto 1963, the total number of banks to which moratoria were granted was 42. The total deposit involved in the moratoria amounted to Rs 22 crores. Of these 42 banks, 32 banks were amalgamated with other banks. One was allowed to go into voluntary liquidation; one was allowed to amalgamate voluntarily with another bank; three were ordered to be wound up and in respect of one, a scheme of arrangement was sanctioned by the court and the order passed for its dissolution. In respect of two banks, the moratorium was allowed to lapse on the guarantee of directors while the future set up of the two remaining banks which were under moratorium was still under consideration.[18]

A third development making for increased confidence has been the amendment to Section 17 of the Banking Companies Act 1949, which is meant to strengthen the capital reserves of commercial banks. The amendment requires a banking company to continue transferring each year to its reserve fund, a sum equivalent to not less than 20 per cent of the profit, even after the reserve fund equals the paid-up capital. Before this amendment, Indian banks (foreign banks were not included) were required to

1. R.B.I. Bulletin, April, 1964, pp. 470, 471.

transfer to reserves not less than 20 per cent of their balance of profit until the reserves together with the share premium amount equalled the paid-up capital. Now even banking companies incorporated outside India are required to deposit with the Reserve Bank an amount calculated at 20 per cent of their annual profits in respect of all business transacted through their branches in India. It has, however, been provided that the Central Government may, on the recommendation of the Reserve Bank, grant exemption from the requirement of this annual appropriation to any banking company, whose reserve fund, together with any balance in the share premium account is not less than the amount of the paid up capital.

One doubts if the excess of cash or liquidity over statutory requirements can ever be completely eliminated especially in a country where demand for credit is seasonal and not uniform. But a Central Bank faced with such persistent inflationary pressures as the Reserve Bank of India, should aim at reducing this excess to a minimum. There may, therefore, be genuine dissatisfaction with the fact that after all the experience of the past, the Reserve Bank should have chosen to fix the cash-deposit ratio at 3 per cent when with less liquidity in the economy and a less rapid growth in the supply of bank money, this ratio was higher at 3.25 per cent.

It is true that if the ratio was to be fair to all, the case of the weaker banks had also to be considered. But when a choice has to be made between continuing inflationary pressures and helping the weaker banks, we should think of the former rather

than of the latter. As for the latter, the Reserve Bank can, if it is so disposed, assume powers for their compulsory merger with some of the bigger banks of the country. As long as that is not done, the statutory reserve requirements are likely to leave the bigger banks with enough room to manoeuvre inflationary expansion in money supply.

CHAPTER 13

SELECTIVE CREDIT CONTROL

Selective Credit Controls, as they are normally exercised, includes

(i) the use of all the weapons of quantitative control selectively,

(ii) raising of margin requirements against certain collaterals;

(iii) setting a ceiling on advances against selected commodities;

(iv) control of consumer credit;

(v) pre-import deposit requirements.

It is possible to use selective credit control 'as an adjunct to the long term process of development' or as a short-term expedient.[1] Generally, however, they are used 'as a short-term ant-inflationary measure or in order to prevent some of the usual side effects of inflation'.[2]

As for using a quantitative control weapon selectively, the Central Bank may fix a basic discount rate from which it allows deviation either side with a view to encouraging or discouraging commercial bank borrowings for certain purposes. The Central

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1. 'Selective Credit Controls in Under-developed Economies': I.G. Patel, I.M.F. Staff Papers, September, 1954, p. 76.
2. Factors in Economic Development: A.K. Cairncross, 1962, p. 164.

Bank may prescribe discriminatory eligibility requirements, going even to the limit of refusing to rediscount certain papers like consumer instalment credit, export import bills etc.[3]

It may also be laid down that papers of certain institutions like a development bank which has been specially set up to look to the needs of development of the economy will be given preferential treatment.

Selective controls may also take the form of regulating the reserve or liquidity ratios in such a way that preferred kin of loans and assets are encouraged and undesirable kind of assets and loans are discouraged.

It will be generally accepted that if a given rediscount policy in under-developed countries is combined with a selective use of such other weapons as minimum reserve requirements, the chances of its success greatly improve. If, for example, the Central Bank has through increased reserve requirements made it inevitable for commercial banks to borrow from it, the rediscount rate can become more effective. The same result can be possible if the Central Bank withdraws its support from the Government securities market. For then the commercial banks would think twice before unloading their securities to replenish their liquidity because of the fear of capital depreciation.

In short, it would be difficult to believe that the wielding of any single weapon selectively would achieve its purpose. Perhaps, a number of weapons will have to be simultaneously wielded.

(4) The idea behind raising the margin against collaterals is

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3. <u>Foreign Central Banking</u>: Peter G. Fousek, p. 71.

that borrowers borrowing on the strength of such collaterals would be in possession of smaller loans than before unless they can manage to quantitatively enlarge the possession of the collaterals themselves. But in that direction, they may have a smaller incentive now that their value as 'loan catchers' has gone down.

Against this method there are such difficulties as valuation of the collateral which may be arbitrary. But this is a difficulty with valuation and not with the principle of margin requirements. Further if it affects inventories, it may cause hardship to small merchants for whom a reduction in loans might mean reduction in sales, income etc. This difficulty can be overcome by providing that increased margin requirements will be applicable to increases in inventories rather than to their current level.

However, commercial banks may decide to increase loans not covered by collaterals and thus defeat the purpose of margin requirements. But this may be remedied by restricting uncovered loans.

On the whole, it does not seem to be an ineffective weapon of selective credit in control if it is wielded in the context of a generally restrictive credit policy. It is specially useful in curbing, speculation in stocks or a tendency to build up real estate, both of which can be serious dangers in under-developed economies where stocks and collaterals real estate are frequently advanced as collaterals against commercial bank borrowing.

The practice of hire purchase amongst consumers is not very common in under-developed countries at present. But if such a

practice does increase because the beginnings are now being made especially in respect of such goods as radios, electric fans, sewing machines, etc., selective credit control will have to be appropriately administered.[4]

A new weapon of selective credit control not yet used in Asian countries but quite fascinating chiefly because of its novelty is that of advance deposit on imports.[5]

This method requires that those possessing a license for imports should deposit with the central Bank a certain percentage of the value (in fact this percentage could be as high as 100) they intend to import, in advance of the actual time of making payment. Ordinarily if an importer who has placed his orders abroad expects goods to be delivered after, say, three months, he might approach his commercial bank for the necessary loan after three months or so. In this case since the central bank requires a deposit in advance, the importer will have to borrow from the commercial banks earlier. The precise time of his borrowing will, of course, depend upon the details of this policy. It may be a few days or a few weeks or even a few months before the date of payment.

It is clear that if importers have to borrow from commercial banks earlier than they would have normally done, they would have borrowed for a longer total period. For in any case they cannot begin repaying their loans unless the imports have been received

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4. Cairncross, op. cit., p. 166.
5. 'Advance Deposits on Imports', Jorge Marshall, I.M.F. Staff Papers, April, 1958, p. 239.

and sold in the market. This forced expansion of the period for which loans have to be borrowed will raise the importer's cost of financing a given volume of imports and thus reduce his capacity to sell imports at home in competition with domestic goods whose prices in the meanwhile might have remained constant. In fact with such a policy as this, domestic prices might have even come down to a lower level. Since the importers have to deposit their advance with the Central bank, the commercial banks' reserves would have been reduced to the extent of the volume of deposits so made over. This reduction would reduce the capacity of the commercial banks to create deposits and bring down the quantity of money in circulation in the economy. When the quantity of money in circulation has gone down, domestic prices might be stabilised or even brought down to a lower level. If the reduction in domestic prices coincides with a reduction in money incomes, this might reduce the demand for import even apart from the effect of increased competition from domestic products. Further since the commercial banks might feel reluctant to agree to financing imports because it will reduce their capacity to create deposits for an arbitrary period, this may raise interest rates and reduce the competitive capacity of importers by a further margin. On the other hand, higher interest rates might induce an inflow of short period capital from abroad partly because the importers themselves have been pressing for foreign financing of their imports in view of a higher interest rate at home. If this happens, the balance of payments would tend to be less favourable.

Thus, it is said, "The effect of advance deposit on the balance of payments will be .... threefold : import demand will be more difficult to satisfy because of increasing costs and financing difficulties; to the extent that advance deposits are actually made and funds shifted from the commercial banks to the central bank, there will be a reduction in money income and consequently in import demand; and to the extent that interest rates are stiffened, more financing will take place broad and there will be an inflow of short term capital with a favourable temporary effect upon the balance of payments and the level of foreign reserves."[6]

However, in actual life, the effects may be different from those just pointed out. For after all, such effects rest on certain conditions which may or may not obtain.

For example, a higher cost of financing a given volume of imports could be neutralised by a decline of the prices of imports themselves. Those exporting their commodities might try to bring down costs through technical progress for fear of a decline in their markets.

Further, if the elasticity of demand for the imported articles is low, higher costs might not make much difference to the demand for imported commodities. This will be so if imported commodities are things like medicines, capital equipment etc.

As for the effect on commercial banks' capacity to lend, three factors are important:

(a) the commercial banks might already be operating with

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6. op. cit., pp. 248, 249.

sufficiently excessive reserves so that loss of some of it to the central bank through import deposits may not handicap deposit expansion,[7]

(b) there may be foreign banks engaged in import financing who could always replenish their reserves from their head office;

(c) the commercial banks might like to put against this handicap (if it is there) the advantage of a commission on foreign exchange which they get from their importer clients.

As for the possibility of an inflow of short term capital in under-developed countries, it is very remote indeed unless it is through foreign banks from their head offices for replenishing the reserves of those banks consequent upon the depletion occasioned by the transfer of some of their funds to the central bank.

The most important limiting factor in the case of some under-developed countries (so far as pre-import deposit technique is concerned), however, might be the low proportion which imports constitute of the total national income of the economy. In India imports are only about 7 per cent of the national income at present. And a very high percentage of these imports is of such essential commodities as raw materials, food, capital equipment etc.

The methods of selective credit control which the Reserve Bank of India has been resorting to are (i) varying the margin requirements against certain collaterals (food grains, sugar, oil seeds, raw-jute, jute goods, shares etc.), (ii) exempting certain collaterals with a view to encouraging selected institu-

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7. Patel, op. cit., p. 83.

tions and (iii) fixing ceiling limits on advances against selected commodities.

The first directive imposing selective credit control in India was issued in 1956.[8] It concerned advances against paddy and rice. Since then a large number of directives in respect of advances against essential food articles such as paddy and rice, wheat and other food grains, sugar, groundnuts and other oil seeds have been issued from time to time. On March 11, 1960, selective credit control was extended to include advances against equity shares as a check on speculation in the stock market. Such speculation, as is well known, is sometimes aggravated by rising bank credit against this security.

Selecting credit controls cover all scheduled banks; the non-scheduled banks and cooperative credit institutions are out of the scope of the directives. At first the directives used to be applied less rigorously. For example, directives issued in 1956 and early 1957, covering paddy and rice, wheat and other food grains sought to bring about a reduction in advances through prescription of minimum margin requirements and by prohibiting any increase from the existing credit limits or grant of fresh limits beyond Rs 50,000. The request to banks to bring down the level of advances was not mandatory. Since mid-1957, the request was made mandatory and the banks were under obligation to maintain advances below specified levels. Since then the margin requirements have also been very often raised.

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8. Evolution of Central Banking in India: Sir B. Rama Rau, November, 1960, p. 54.

But despite this two pronged attack, it was found that the desired results were not produced. The banks began to maintain an over all All-India limit in their advances by increasing bank advances in surplus States and reducing them in deficit ones. In the surplus States, where bank advances started rising out of proportion to the output and the marketable surplus, inventory accumulation rose higher than it should have done. On the other hand, in the deficit States, bank advances as a proportion of output and marketable surplus began to decline, thereby leading to a reduction in inventories below desirable levels. This raised prices where there was surplus and lowered prices where there was a deficit. To remedy the situation in December 1957, the Reserve Bank laid down specified levels for advances in surplus States along with other all levels for the country as a whole.

To introduce flexibility, it was decided in 1959 when the State Governments embarked upon a programme of procurement that in fixing ceiling limits for advances the change in the position of traders' stocks after procurement should also be carefully assessed. The over all limits themselves were not arbitrarily fixed but took into account the level of production, estimated marketable surplus and the finance that might be necessary. In cases were production was larger than in the previous year, a higher credit level was allowed. The 110% level in relation to the previous year fixed for advances against sugar in the directive of June 29, 1957 is a case in point.

The selective credit controls have taken care that production

and movement of goods[9] are not affected and that only excessive inventory accumulation is discouraged. For this reason, these controls do not interfere with credit against documentary bills covering movement of commodities. Exported groundnuts, Vanaspati, cotton and sugar have been generally exempted from the purview of these controls. Advances to roller flour mills against wheat, and to rice mills against paddy and rice, have also been favourably treated. Advances to cooperative processing and marketing societies, advances against warehousing receipts issued by the State or Central Warehousing Corporation as well as advances by new offices of banks, have some times been given concession with a view to encourage popularisation of cooperatives, warehouses and the new banks. In order that small investors were not hampered by the directives restraining the volume of bank credit on equity shares, advances of Rs 5,000 or less were exempted. Further, advances to share brokers by way of purchase of demand bills covering stock exchange securities, to be despatched from one centre to another, were exempted provided the bills were returned within seven days of their purchase by the banks.

The two principal means of selective credit control in India are, as we have already seen, varying the margins on collaterals and setting the over all level of advances permissible against them. In the beginning, on account of the difficulty of passing on the Reserve Bank's directives to the far flung branches of banks, there was some confusion which created the impression that the Bank's directives were not being carried out. How-

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9. 'Central Banking in India': S.L.N. Sinha, in _Central Banking in South and East Asia_, ed. S. Gettyn Davies, p. 40.

ever, the net position has not been vary unsatisfactory. Both in the matter of the margins and also in that of the level of advances, commercial banks have appeared as being willing to carry out the Reserve Bank's directives. One exception to this has been their performance in 1959 when in the case of 'other food grains', i.e., other than paddy, rice and wheat, the banks did exceed the permitted levels through most of 1959, the magnitude of the excess becoming more pronounced after June. Thus at their peak level in June, the advances adjusted for exempted categories were Rs 75 lakhs above the permitted level. In the following two months, the excess was as much as Rs 2 crores though subsequently the trend was downward. The excess was occasioned by the substantial rise in ourturn in 1958-59 season over that of the previous year which was comparatively, a poor crop year. The excess was also occasioned by the need for making good the deficiency in stocks which had declined to rather low levels. In 1960, however, advance against 'other food grains' remained within the permitted level.

The year 1960 saw two developments in the sphere of selective credit control. One was relaxation of regulation in respect of advances against sugar and the other, the imposition of regulation on advances against raw jute and jute goods. On December 9, 1960, the minimum margin requirement on advances against the security of sugar to parties other than those manufacturing sugar and in respect of stocks which had left the factory or mill premises and on which excise duty had been paid were reduced from 45 per cent to 25 per cent in view of the improved stock position and the stability in sugar prices.

On December 12, 1960, the Reserve Bank issued a directive by which advances against raw jute and jute goods were brought within the purview of selective credit controls. This was done because of the upsurge in the prices of raw jute and jute goods in the context of a significant rise in advances against the security of these commodities. The directive stipulated -

(i) a minimum margin of 25 per cent on advances against raw jute to jute mills and 40 per cent on such advance to others;

(ii) a minimum margin of 40 per cent on advances against jute goods; and

(iii) an average aggregate level of credit against the security of jute goods in each two month period commencing from January 1961 which should not exceed 130 per cent of the average level of credit maintained by a bank in the corresponding two month period in the immediately preceding year.

In 1961-62, the controls in the case of advances against paddy and rice, groundnuts and shares were relaxed while those in respect of sugar, wheat, raw jute and jute goods and clean advances were withdrawn.[10] The permissible limits on advances against paddy and rice for each two month period commencing from March 1, 1962 during the period March 1962 and February 1963 were raised to 105 per cent of the levels permitted to be maintained in the period March 1961 - February 1962 separately in respect of some States. The revised directive issued on February 28, 1962 on advances against paddy and rice also provided for the continuation of concessional facilities regarding credit limits

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10. Report on Currency and Finance, 1961-62, pp. 53-54.

enjoyed earlier by banks operating in Kerala and Punjab. On May 10, 1962, the Reserve Bank amended the directive on advances against paddy and rice and made provision for an ad hoc increase in the permissible levels of banks operating in Orissa State so as to enable them to meet the increased credit needs of rice millers and traders in the State.

Under a revised directive issued on February 28, 1962, the credit celings for individual banks for each two month period during 1962-63 (March - February) commencing from March 1962, were fixed at 105% of the levels permitted in the corresponding period of 1961-62 (March - February).

On April 19, to enable integral oil expeller mills to purchase and store groundnuts for extracting de-oiled groundnut cake for export, banks were permitted to extend additional credit facilities to such mills in excess of the ceiling limits up to 25% of the f.o.b. value of their actual export of de-oiled or de-fatted groundnut cake in the corresponding period of 1961-62 (March - February). In view of the relative stability in scheduled banks advances against shares since the imposition of controls in March 1960, the introduction from December 1961 of a system of uniform and atutomatic margins in all stock exchanges ensuring a greater measure of internal discipline in their operations and the operation of the Reserve Bank's general credit controls, a reduction in the minimum margin requirement on advances against ordinary shares of joint stock companies from 50% to 40% was made effective in January, 1962.

As for advances against sugar and wheat, controls on such

advances had been lifted in April and May 1961. In June 1961, in the context of the decline in advances against jute goods, and prices of jute goods, the restriction on minimum margin in respect of advances against jute goods was withdrawn. With the improvement in the supply of raw jute and a further fall in the prices of raw jute and jute goods, the remaining restrictions against raw jute and jute goods were also withdrawn in August, 1961.

In 1960, the Reserve Bank had imposed control on clean advances to prevent possible circumvention of selective credit controls through the extension of clean loans. On October 23, 1961, the regulatory provision relating to such advances was also rescinded in view of the removal of controls on advances against sugar, wheat, raw jute and jute goods and also in view of the operation of general credit control which seemed to have resulted in a higher pattern of lending rates. This pattern appeared as restricting unessential demand for credit. With a view to providing an incentive to scheduled banks to increase their lending to small-scale industries and cooperative institutions, the Reserve Bank issued a circular on December 11, 1961, permitting scheduled banks to borrow from the Bank at the Bank Rate, in addition to their basic quota, an amount equivalent to the excess of the average of their outstanding advances to small-scale industries and cooperative institutions as on the last Friday of each month during the half-year January - June 1961 over the corresponding figures for the year January - June, 1960, provided that the amount was not less than Rs 1 lakh.

Thus the year 1961-62 saw some relaxation in selective credit controls. This was because of the satisfactory price situation.

The year 1962-63 was, however, different. Upward pressure upon prices was exerted by such food articles as rice, pulses, milk and ghee, sugar and gur, tea and coffee.[11]

The Reserve Bank decided to extend selective credit control to advances against warehouse receipts covering food grains were, at first, exempted from the purview of such control, both in respect of ceilings and also of margins, with a view to increasing development of warehouses and the use of warehouse receipts as security for bank advances. It was, however, observed that a large part of the rise in advances against paddy and rice and other food grains (excluding wheat) which occurred during the greater part of the year was accounted for by advances against wharehouse receipts. It was, therefore, considered necessary to introduce some measure and regulation in regard to advances against these receipts, if selective credit control was not to be rendered ineffective. And, therefore, the Reserve Bank issued revised directives on January 23 and March 11, 1963, withdrawing the exemption hitherto granted in respect of advances against warehouse receipts covering stocks of paddy and rice and other food grains (excluding wheat) and imposing on such advances a margin of 25% as compared to 35% for other advances, i.e., advances against food grains (excluding wheat) other than advances against warehouse receipts. Under the revised directives the ceiling limit for advances against paddy and rice and other

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11. Report on Currency and Finance, 1962-63, p. 44.

food grains for each two month period commencing from January - February, 1963, and for March - April, 1963, in respect of advances against 'other food-grains' were fixed at the average aggregate of advances maintained in the corresponding period of 1962. These limits were at first inclusive of advances against warehouse receipts in the corresponding period of 1962. However, by the directive issued on May 16, 1963, ceilings were placed on bank advances other than those against warehouse receipts within the overall ceilings prescribed in the earlier directive, the balance being available for advances against warehouse receipts. Further the banks could make advances against warehouse receipts out of the limits fixed for other advances. Advances against receipts of warehouses established by the Central and State Warehousing Corporations on or after April 1, 1962 were exempted from the operation of the overall ceilings.

On January 25, 1963, the Reserve Bank modified its earlier directive relating to groundnuts and other oil seeds. In view of the discontinuance of the system of registration of export sales contracts by the Export Trade Control authorities, the provision contained in the February 28, 1962 directive in regard to additional limits allowed to banks on account of credit extended to exporters of H.P.S. groundnuts was modified. The revised additional limits for the two month period January - February, 1963 were fixed at 200% of the additional limits permitted to banks in the corresponding period of 1962. The ceiling limits fixed by the above mentioned directive in respect of advances against groundnuts lapsed at the end of February 1963. After that bank advances against groundnuts and

other oil seeds were only subject to minimum margin requirements of 45% and 40% respectively. In view of the comparatively easy trend in groundnut prices, it was not considered necessary to continue the control on ceiling limits for advances against groundnuts.

On April 27, 1963, the firmness of sugar prices arising out of anticipations of lower output in the 1962-63 season and the spurt in bank advances to parties other than those manufacturing sugar, prompted the Reserve Bank to issue a directive to scheduled banks prescribing a minimum margin of 45% on credit limits or advances granted to parties other than those manufacturing sugar. Such margin requirements were also to apply to credit limit or advances granted to parties manufacturing sugar in respect of stocks which had left the factory or mill premises and on which excise duty had been paid. The directive of August 30, 1963 exempted advances against stocks of sugar granted to consumers' cooperative stores from margin requirements.

An important development in 1963 was the discontinuance of the minimum margin of 40% on advances against ordinary shares of joint stock companies.[12] This margin had been imposed in January 1962. The directive of October 30, 1963, which had suggested the discontinuance retained, however, the ban on investments in 'budla' transactions by banks.

The general approach in the directive of February 8, 1964 was, more or less the same as that in the directives of the preceding few months. Only that the details of the ceiling limits

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12. Report on Currency and Finance, 1963-64, p. 49.

for advances against paddy and rice and other food grains in respect of the newly established offices and branches of banks were spelt out, with some modifications, in a greater detail. Also, the exemption from ceiling limits on advances against warehouse receipts issued by the new warehouses was further extended to advances against warehouse receipts issued by the warehouses opened since January 1, 1961. This was done to ensure adequate bank credit for financing the storage of grains in comparatively new warehouses.

There was a slight tightenting of credit against groundnuts when on March 11, 1964, the Reserve Bank raised the minimum margin to 50%. This was 5 percentage points higher than the earlier margin; the margin on advances against other oil seeds continued unchanged at 40%. The average aggregate level of credit against groundnuts during March - April, 1964, was not to exceed 130% and the level in each subsequent month was not to exceed 120% of the average aggregate level of credit respectively maintained in the corresponding two month period of 1963, in respect of credit granted to all parties.

The scheduled banks were required to maintain in each two month period commencing from January - February 1964, average aggregate levels of advances against paddy and rice, including advances against warehouse receipts, equal to 90% of the levels of such advances maintained in the corresponding period during 1962. As in the earlier directive, a secondary ceiling in respect of non-warehouse advances was fixed at 90% of the level of such advances maintained in 1962; the continuance of this special

feature being intended to minimise any adverse impact of the control on the development of warehouses.

In view of the fact that by July 11, 1964, the wholesale prices of commodities appeared to be rising at the staggering rate of 33.6% per annum, the Reserve Bank of India decided to apply stricter control over advances against food grains.

In the directive issued on August 17, 1964, the Reserve Bank directed the scheduled banks to maintain, with immediate effect, minimum margins of 50% instead of the earlier 35% on their advances against the security of paddy and rice and wheat and 'other food grains'.[13]

The minimum margin on advances against warehouse receipts covering food-grains was also raised from 25% to 40%. Further, the Bank reduced the ceiling limits in respect of advances against 'other food grains' (other than paddy, rice and wheat).

The banks were now required to maintain during each two month period commencing from September - October, 1964, an average aggregate level of credit against the security of 'other food grains' which was not to exceed 90% of such level of credit actually maintained in the corresponding two month period of 1962. Earlier, the ceiling limits had been fixed at 100% of the 1962 level.

The principal purpose behind selective credit controls has been to strengthen forces which help in the stabilisation of the prices of certain commodities. In India, they have attempted to arrest undue expansion of credit against a few important commo-

13. R.B.I. Bulletin, August, 1964, p. 993.

dities in the busy season and undue contraction of credit during the slack season.[14]

It is true that the problem of enforcement of selective credit controls in an economy like India's is difficult. The banks have widely differing assets and liabilities structures. They have also different standards of management and fairly extensive net-work of far flung branches. However, even when the banks have, by and large, tried to fall in line with selective credit control directives, the selective credit controls have not helped much in the stabilisation of commodity prices.

We might recall that credit control measures concerning foodgrains were revised in December 1958. The scheduled banks' advances against food-grains fell from Rs 23 crores in April 1958 to 20 crores in April 1959. Yet the index number of wholesale prices of food-grains showed a comparatively large rise from 105.2 in April 1958 to 113.1 in April 1959, against a rise in the index number for all commodities from 107.4 to 112. More recently, even despite the fact that there has been a tightening up of control against paddy and rice and a re-imposition of the control on advances against wheat, prices of these commodities have been going up. In paddy and rice, the over-all ceiling, as well as the secondary ceiling in respect of non-warehouse advances, was fixed in February 1964 at 90 per cent of the level of such advances maintained in 1962. Yet the wholesale price index of rice rose from 121 in February 1964 to 140 in July 1964. In April, 1964, the minimum margin on advances against wheat was reimposed at 35 per cent, while the ceiling limit for each two

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14. Monetary Policy and Economic Growth: H.V.R. Iengar, p. 203.

month period beginning from May-June 1964 was fixed at 80 per cent of the levels maintained in the corresponding two month period in 1962. Yet the wholesale price index of wheat rose from 116 in April 1964 to 119 on July 25, 1964.[15]

The thing is that as long as selective credit controls are imposed in midst of a liberal money environment they would not succeed much in achieving the desired result. This is because money can find resting places other than a commercial bank also. Once money is unguardedly created, the liquidity of the economy increases and stockists who are disappointed at commercial bank counters get heard in other quarters.[16]

There is another reason also why liberal money can defeat the purpose of a selective control of credit. As the Indian experience has shown, rising prices, resulting partly if not wholly from a liberal money policy, aggravate income inequalities and increase the staying capacity of businessmen and traders. They add to that capacity through enlargement of tax evasion and black money, as well. Thus to some extent, self-financing of inventory accumulation and avoidance of dependence on commercial

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15. R.B.I. Bulletin, August 1964, p. 1099.
16. '..... Selective regulation of credit could be more successful if it supplements a measure of general reduction of liquidity than if it is operated independently.' B.K. Madan, Aspects of Economic Development and Policy, p. 168.

As the report of the Central Board of Directors of the Reserve Bank of India accepts, 'they (selective credit controls) have their limitations, especially in an environment of overall monetary expansion, which makes it possible for operators to resort to non-banking sources of finance'.
(R.B.I. Bulletin, August, 1964, p. 1018).

bank credit is made possible. To the extent that this happens, liberal money policy and selective credit controls go ill together. In the words of Shri H.V.R. Iengar, 'In India, as in other countries, the efficacy of selective credit controls has always been more pronounced when they operated in the context of a generally restrictive credit policy, as for instance, in the summer months of 1957 when the Bank rate was raised by ½%. On the other hand, their efficacy is impaired if they operate in the context of liberal borrowing from the Reserve Bank or of high liquidity with banks'.[17]

It is interesting that despite this realisation by no less a person than a Governor of the Reserve Bank himself, we have continued to follow a generally liberal rather than a generally restrictive monetary policy.

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17. op. cit., p. 204.

CHAPTER 14

LONG TERM FINANCE IN THE INDUSTRIAL SECTOR

In India, the commercial banks are, by and large, reluctant to take much interest in long-term financing of investments. Their reluctance is due to non-availability of suitable securities, risks of default, difficulties in the realisation of loans, inadequacy of funds available for long-term investments etc. They do not therefore, normally engage themselves in long-term industrial investments except where the short-term loans get converted into the long term ones through continuous renewals.

The industrial advances by scheduled and non-scheduled banks rose from 32.5% of their total advances in 1951 to 53.5% in 1961. This means a rise of about 65% in short-term lending operations of the commercial banks.

The scheduled banks' investments in securities have also shown a considerable increase. The index of investments (1951 = 100) in gilt-edged stood at 256.4 and 189.8 at the end of 1959 and 1961 respectively. However, the index of investment (1959 = 100) for the same period in industrial securities was 187 and 147.9 respectively. The investments in Government securities during the period accounted for more than 90% of the total investments(except in 1961), whereas the share of industrial securities was on an average, only 2.8% of the total investments. Moreover, the investment in industrial securities showed a fall

at an average rate of 0.32% (based on mean deviation) up to 1958.[1] After that, there was an increase in the banks' investments in industrial securities. But this increase was not significant compared with the relative increase in the investment in Government securities. On an average, only 1.2% of the total deposits have been invested in industrial securities and this is very small, as compared to the investments in Government securities.

It is thus clear that the commercial banks have invested much more in short-term than in long-term investments.

Nor have the banks done much by way of under-writing new capital issues.

According to the study made by Dr. G. Balkrishnan of Company Law Administration,[2] 32.1%, 19.2% and 16.2% of the total amount were under-written by banks in 1959-60, 1960-61 and 1961-62 respectively. Only 8 banks in 1959-60, 6 banks in 1960-61 and 10 banks in 1961-62 were engaged in under-writing. Of these, the main under-writers were Devakaran Nanjee Banking Co., the Central Bank of India, the United Commercial Bank, and the Bank of India. According to another study made by the Economic Times,[3] during the first half of 1963, only 7.9% of the total amount under written had been taken up by the Banks.

Institutions of Long Term Finance

Facilities for long term finance in India were, therefore, especially created through the Industrial Finance Corporation of

1. 'Investing Bank Funds in New Capital Issues', K.M. Upadhyay, Supplement to "Capital" of 19th December, 1963, p. 151.
2. Ibid.
3. Ibid.

India, the 15 State Financial Corporations, and the Industrial Credit and Investment Corporation of India. In addition, the institution of Refinance Corporation for Industry was created in order to assist commercial banks and induce them to lend for a long period. The Reserve Bank of India also operates a guarantee scheme in order to encourage lending institutions to grant loans to small-scale industries. Moreover, the National Small Industries Corporation procures industrial equipment for small entrepreneures under a hire-purchase arrangement. The National Industrial Development Corporation, also a Government agency, has been established with a view to rehabilitate industries by granting them long term assistance. The Film Finance Corporation seeks to meet the special needs of the film industry which has not been able to obtain finance through normal channels. Many State Governments have recently started Industrial Development Corporations in their States. While the Government of India have set up the Agricultural Refinance Corporation, the Industrial Development Bank and the Unit Trust of India, all with the object of helping the financing of long-term investments in the country.

Let us go into the working of some of these special institutions of long-term finance briefly.

<u>Industrial Finance Corporation</u>

This Corporation was set up under an Act of Parliament in the year 1948. It has paid-up capital of Rs 5 crores. Sixtyfour per cent of the total shares of the Corporation are owned by the Government, Reserve Bank of India and Life Insurance Corpo-

ration and the rest by scheduled banks and insurance companies. Individuals are not allowed to become share-holders. The Corporation sells debentures in the market in order to increase its resources. At the end of March, 1960, the total amount of bonds outstanding was Rs 22.24 crores. This marked an increase of about 17 crores on the amount raised through bonds and debentures in March, 1952. The Corporation can borrow from the Central Government in case it faces any deficiency in its balances. This facility was provided by a law passed in 1955. Arrangements have been made to enable the Corporation to make loans in foreign currencies (a foreign currency loan of $ 10 millions) has been sanctioned by the U.S. Development Loan Fund to be used by the Corporation in extending loans to the industrial concerns in the private sector); and loans aggregating to Rs 3.48 crores were sanctioned for disbursement in U.S. dollars to about a dozen concerns during the year 1960-61.

The principal function of the Industrial Finance Corporation of India has been advancing loans to industrial concerns. The rate of interest chargeable on such loan is 7% with possibility of a rebate of ½% in a case there is a prompt repayment. The loans and advances of the Corporation rose from Rs 6.55 crores in March 1952 to Rs 40.74 crores in March, 1961. The Corporation also under-wrote four issues of shares in 1960-61, involving a total commitment of Rs 1.60 crores, compared with two issues with a total commitment involving only Rs 88 lakhs in 1959-60. In suitable cases, the Corporation also encourages deferred payments relating to imports by providing a guarantee. Eight applications of the value of Rs 13.13 crores and referring to deferred

payments were sanctioned in 1960-61; and in 1959-60, only six applications accounting for Rs 7.79 crores were sanctioned.

The Industrial Finance Corporation Act was amended in December 1960 in order to give the Corporation wider powers relating to grant of loans and deferred payments, subscription to stocks and shares of industrial concerns and conversion of loans granted (or debentures subscribed) by the Corporation into stocks or shares of the industrial concerns in question. If industrial concerns borrow from scheduled banks and State Co-operative Banks or float loans in the market, the Corporation has the power to guarantee such loans. The facility arising out of guarantee for deferred payment need not relate only to imported capital goods; it will include capital goods produced in the country also. Even foreign loans taken by industrial concerns may be guaranteed by the Corporation if the Central Government has no objection. The privilege of participation in the equity capital of industrial concerns has not yet been adequately utilised by the Corporation.

The State Financial Corporation Act was passed in September, 1951 and since then, Corporations have been organised in all the 15 States. In March 1961, the loans and advances given by the 15 State Corporations amounted to Rs 17.12 crores. In March, 1956 when the number of Corporations was only 12, the loans and advances given, amounted to Rs 2.72 crores. These Corporations issued bonds and debentures for the first time in 1956-57; the total amount involved in such issues was Rs 36 lakhs; on the last Friday of March, 1961, however, funds raised through bonds and debentures amounted to Rs 7.17 crores.

The major beneficiaries of the facilities granted by the I.F.C.I. were sugar industry, cotton textiles, paper, chemicals and cement. As at the end of June, 1960, 30% of the total loans sanctioned went to sugar industry, 74% of the loan to sugar industry going to sugar co-operatives. The loans granted to paper, cotton textiles, chemicals and cement amounted to Rs 9.74 crores, Rs 9.63 crores, Rs 9.38 crores and Rs 6.17 crores respectively. These four, along with sugar industry, absorbed more than 71% of the total loan amount. The loan granted to rayon industry was of the order of Rs 3 crores. The interesting thing in respect of the loans given by the Corporation to food manufacturing and textile industries is that in many cases the loans exceeded the amount of the paid-up capital of the respective companies. The same is the case with chemicals, glass and glass products and electrical machines, motor vehicles and ancillaries though the excess in these cases may not be as much as in the case of food manufacturing and textile industries. This shows that for some beneficiaries of the I.F.C.I. loans, the Corporation was the most important source of finance compared to even their paid-up capital.

On the whole, the I.F.C.I. has been making a considerable contribution in financing industrial development in the country. A liberal estimate of the I.F.C.I.'s contribution in financing the public limited companies indicates that the corporation has financed about 8 to 10% of the total external long-term finance in the entire class of public limited companies.[4]

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4. Institutions of Industrial Finance in India, M.S. Joshi, The Journal of the Indian Institute of Bankers, October, 1961. p. 292.

The Industrial Credit and Investment Cor oration of India

This Corporation was registered under Indian Companies Act in January, 1955. It is supposed to assist limited liability concerns in the private sector through such facilities as granting long-term loans, under-writing issues and guaranteeing loans. The feature which distinguishes it markedly from similar other Corporations is that it subscribes to the equity capital of private business enterprises.

The Corporation has a paid-up capital of Rs 5 crores of which Rs 2 crores are subscribed by Indian banks and insurance companies etc., and Rs 1.5 crores by the general public. Subscribers in the U.K. and U.S.A. hold Rs 1 crore and Rs 0.5 crore respectively.

In 1960, the Corporation's financial assistance given to 44 companies aggregated to Rs 13.43 crores. This was an improvement upon the Corporation's performance in 1959 when the assistance covered only 27 companies and aggregated to Rs 8.41 crores. The assistance was in the form of rupee loans and share subscriptions (including under-writing commitments) and in the form of foreign currency loans. Rupee loans, share subscriptions and under-writing commitments amounted to Rs 5.81 crores; foreign currency loans amounted to Rs 7.62 crores. The amount actually disbursed in 1960 was, however, Rs 3.11 crores compared to Rs 2.99 crores in 1959. The Corporation was required to take Rs 1.23 crores in fulfilment of its under-writing commitments of Rs 1.72 crores relating to five operations completed during 1960. Since its inception and up to the close of 1961, the Corporation made a total disbursement of Rs 12.46 crores of which rupee loans accounted for Rs 3.97 crores, ~~foreign currency loans for Rs 3.97~~

crores foreign currency loans for ₨ 3.54 crores, direct subscription to shares, ₨ 1.99 crores and under-writing operations ₨ 2.96 crores. The foreign resources of the Corporation are naturally augumented through borrowing from foreign sources. The total World Bank loans to the Corporation at the end of 1960, amounted to $ 40 millions (equivalent to ₨ 19.04 crores). The Development Loan Fund of the U.S.A. also approved another loan of $ 5 millions (equivalent to ₨ 2.38 crores) during 1960.

As has been mentioned before, this Corporation's exlusive interest is industry in the private sector; as such, it is in a position to mobilise foreign resources for the private sector much better. Thus far, the Corporation has been trying to take to safe investments. If the Corporation could concentrate particularly on helping new and promising enterprises even though that might be a slightly risky and not a very profit-making proposition, it would be nice for the industrial growth of the private sector in the country. The Corporation should also try to extend its help in the field of technical and managerial skill. With foreign institutions as its share holders, it should not be difficult for the Corporation to extend such help to Indian enterprises.

<u>The National Industrial Development Corporation</u>

This Corporation was set up in October 1954 with the object of helping balanced growth of industries both in the private and public sectors. The Corporation was primarily intended to rehabilitate important industries and to encourage development of new industrial projects and new lines of production.

The paid-up capital of the Corporation is Rs 10 lakhs, with the Government of India being the sole share-holder. This Corporation thus is an exclusively Government undertaking. Till 31st March, 1961, the total amount sanctioned by the Corporation amounted to Rs 19.59 crores. The actual disbursement till that time amounted to Rs 6.58 crores. These figures indicate a slight improvement over the previous financial year when the total loans amounted to Rs 14.41 crores and disbursements to Rs 5.01 crores. The principal purpose for which loans were granted till then was modernisation and rehabilitation of cotton and jute industries. The Corporation is now extending its activities in other directions as well. For example, whereas in the beginning, the Corporation guaranteed loans given to small-scale industries by selected financial institutions in respect of 22 districts, on 1st July, 1960, the guarantee had been extended so as to cover 52 districts. By 31st March, 1961, the Reserve Bank in its capacity as 'guarantee organisation' received 610 applications involving a sum of Rs 2.08 crores. All these applications were quickly disposed of. The Guarantee Scheme has been partly modified to encourage 'participation' loans and to accomodate State Finance Corporations particularly for loans repayable over a period of more than seven years.

As the only development corporation in India which has the object of promotion of industries, it should have given a much better performance than it has actually been able to give. In fact, an Estimates Committee Report of the Lok Sabha dated 1st April, 1961, recommended that the N.I.D.C. should be divested of its function as a financial agency since these functions could

be performed better by other institutions. The Committee felt that the Corporation was not well-equipped with technical staff and the loans had been given to parties which could have raised their funds themselves. Therefore, the Committee suggested that the Corporation might be dissolved.

Re-finance Corporation for Industries

This Corporation was established in June 1958 with a view to encouraging commercial banks to extend their interest in long-term financing of industry. The idea of the Corporation is to provide commercial banks with facilities of term-loans similar to those traditionally provided by Central Banks for short-term loans represented (mainly) by eligible commercial paper. The Corporation had initially a share capital of Rs 2.5 crores subscribed by the Reserve Bank of India, the Life Insurance Corporation, the State Bank of India and 14 other banks. The facilities of the Corporation were to be given to industries with paid-up capital of more than Rs 50 lakhs but less than Rs 2.5 crores. In exceptional cases the Corporation might consider loans for industrial units with capital and reserves above Rs 2.5 crores.

The primary objective in setting up the Corporation was to channel the American Counterpart Funds earmarked for relending to private enterprises in India, the relending facilities being available to banks advancing loans to such industrial concerns particularly as were included in the Five Year Plans for the purpose of increasing production. Till 1961, refinance facilities had been extended to 43 banks in addition to the 15 who hold shares in the Corporation. Such facilities were also extended to

State Financial Corporations and State Corporative Banks. The loans covered by these facilities were repayable over a period of more than seven years but not exceeding 10 years. In exceptional cases, the Corporation might consider loans for a period longer than 10 years also. Loans to small-scale industries guaranteed under the Government of India Scheme operating since July 1960 were also brought within the scope of refinancing facilities. In 1960-61, the Corporation received 34 applications for refinance totalling Rs 5.63 crores compared with 12 applications accounting for Rs 1.73 crores in 1959-60. The amount disbursed under the sanctions made by the Corporation rose to Rs 1.86 crores in 1960-61 from Rs 1.16 crores in the previous year. Till 1960-61, nearly 90% of the Corporation's funds were lying unutilised with the banks in the form of short-term deposits. Interest on these funds was the principal source of income for the Corporation. Perhaps, the banks found that funds which they could get through deposits from the public could be obtained at lower rates of interest whereas those which they could get from the R.C.I. were a little more expensive. Whatever the reason, the fact of a good deal of R.C.I. funds lying idle is interesting. On the one hand, industries complain that they are unable to meet their capital requirements and on the other, an institution meant for supplying capital is finding its funds idle.

National Small-Scale Industries Corporation

The National Small-Scale Industries Corporation was started in October 1954. It is entirely a Government of India concern and helps small industries in securing orders from Government

departments for the supply of machinery under hire-purchase agreements and by providing guarantee for production loans especially sanctioned by the State Bank. The Corporation has arranged a loan of $ 10 millions from the Development Loan Fund of the U.S.A. in order to be able to finance the supply of imported machinery to small-scale industries on hire-purchase terms.

A picture of the total amount of assistance (long term finance) to different States of India can be had from the following table:

Statewise Distribution of Assistance by Financial Institutions

	I.C.I.C.I.		I.F.C.		S.F.C.		Total	
	Amount Rs crores	Per cent	Amount Rs crores	Per cent	Amount Rs crores	Per cent	Amount Rs crores	Per cent
Andhra Pradesh	3.95	6.6	9.61	5.8	2.98	5.0	16.54	5.8
Assam	1.93	3.2	6.43	3.9	3.96	6.6	12.29	4.3
Bihar	3.04	5.1	9.95	6.1	3.57	6.0	16.56	5.8
Gujarat	6.15	10.2	8.80	5.4	1.41	2.41	16.36	5.8
Jammu & Kashmir	-	-	-	-	0.25	0.4	0.25	0.1
Kerala	0.50	0.8	6.42	3.9	2.82	4.7	9.74	3.4
Madhya Pradesh	0.70	1.2	1.50	0.9	5.02	8.4	7.22	2.6
Madras	6.25	10.4	26.43	16.1	9.59	16.1	42.27	14.9
Maharashtra	19.13	31.8	28.73	17.5	10.36	17.4	58.22	20.5
Mysore	5.73	9.5	12.20	7.4	1.56	2.6	19.49	6.9
Orissa	2.50	4.1	7.29	4.4	1.07	1.8	10.86	3.8
Punjab	1.17	1.9	7.63	4.6	6.41	10.7	15.21	5.3
Rajasthan	0.60	1.0	8.94	5.5	2.26	3.8	11.80	4.1
Uttar Pradesh	3.25	5.4	11.05	6.7	3.95	6.6	18.25	6.4
West Bengal	5.29	8.8	17.41	10.6	4.50	7.5	27.20	9.5
Centrally administered Areas	-	-	1.94	1.2	-	-	1.94	0.7
Total	60.16	100.0	164.33	100.0	59.71	100.0	284.20	100.0

Source : Development Banks Contribute More Finance to Industry: H.J. Parekh, Capital Annual Number, p. 99.

It is interesting to note that there is considerable disparity in the levels of assistance granted to the different States of the country. For example, in the matter of loans given by the I.C.I.C.I., Maharashtra was the luckiest, obtaining as much as 31.8% of the total assistance made available by that institution. On the other hand, shares of such backward States as Madhya Pradesh, Rajasthan were as low as 1.2%, and 1.0% respectively. Maharashtra seems to be leading in the matter of loans obtained from I.F.C. also, her share being 17.5% as against the shares of backward States like Assam and Madhya Pradesh which come to 3.9% and 0.9% respectively. It is a matter for concern that long-term finance seems to be gravitating towards areas which are already developed but not towards areas which need to be developed. The share of the loans the Centrally Administered Areas have received from the industrial Finance Corporation is only 1.2% of the total. This means that the financial institutions which were set up are not helping the achievement of a balanced regional economic development which, apart from economic reasons, is essential for political and social reasons also.

The resources employed by these Corporations are not a direct product of the mobilisation of savings. The total of loans and advances made available by the Industrial Finance Corporation of India and the State Financial Corporations, as outstanding in March, 1961, amounted to Rs 57.84 crores while finance raised by them through issue of debentures and bonds totalled Rs 29.41 crores only. The resources of these institutions are mostly provided by the Central and State Governments, the Reserve Bank of India,

commercial banks and foreign lending agencies; there is practically no non-institutional participation in the share capital of these various special financial agencies.

Agricultural Refinance Corporation

This Corporation started functioning on July 1, 1963. The authorised share capital of the Corporation is Rs 25 crores. Initially, however, the Corporation issued shares of the value of Rs 5 crores, of which the State Cooperative Banks and the Central Land Mortgage Banks took up Rs 135.3 lakhs; the scheduled banks, the Life Insurance Corporation of India and insurance and investment companies, Rs 67.8 lakhs and the Reserve Bank, the balance of Rs 296.9 lakhs. An interest free loan of Rs 5 crores has been provided by the Government of India. The repayment of this loan will commence after 15 years, that is, from 1978.

The rate of interest charged by the Agricultural Refinance Corporation on all types of financial assistance provided by it is 5½ per cent. The minimum amount lent or refinanced by it is Rs 1 lakh. Medium-term loans granted by the corporation will be for a period ranging from 3 to 5 years, while the long-term loans, for the time being, will be limited to 15 years; in exceptional cases, however, their duration may be extended to 20 years.

Thus far the Corporation has approved schemes for land reclamation involving a total financial outlay of Rs 6.38 crores.[5]

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5. R.B.I. Bulletin, August, 1964, p. 1034.

Industrial Development Bank

The Industrial Development Bank of India which commenced its operations on July 1, 1964, is amongst other things, supposed to 'grant direct loans to industries, subscribe to the shares and debentures of industrial concerns, provide refinance facilities, underwrite new issues of shares, guarantee deferred payments of credits for exports, undertake marketing and investment research, carry out techno-economic studies and promote the establishment of new enterprises, especially key industries.[6]

The authorised capital of the Industrial Development Bank would be Rs 50 crores to start with, but with the approval of the Central Government, it could be raised even to Rs 100 crores. The Reserve Bank of India would contribute the entire initial paid-up capital of Rs 10 crores. The Central Government will supplement this amount by an interest free loan of Rs 10 crores. The Development Bank will be entitled to borrow from the Reserve Bank for short periods against trustee securities for periods up to 5 years against bona-fide commercial bills or promisory notes bearing two good signatures, and on long-term, out of the National Industrial Credit (Long-term Operations) Fund set up by the Reserve Bank with an initial credit of Rs 10 crores, this credit being augmented by annual contributions of Rs 5 crores beginning from the year ending June 30, 1965.[7] With the help of the finance of this Fund, the Reserve Bank could, if it liked, buy bonds and debentures issued by the Development Bank. There is also a proposal to set up a special Development Assistance Fund[8] with the

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6. Report on Currency and Finance for the year 1963-64, p. 51.
7. Ibid.
8. Ibid.

help of contributions from the Central Government so that the Industrial Development Bank is able to help projects whose entrepreneurs are, either for the reason that the investment involved is heavy or the return is, immediately at any rate, not likely to be commensurate with cost, unable to raise the necessary finance from banks or other lending institutions. The Industrial Development Bank could, with the prior approval of the Government, borrow foreign currency from foreign banks or other financial institutions. It is expected that this bank, which will be a wholely owned subsidiary of the Reserve Bank of India, would, at some later stage incorporate the Refinance Corporation. Provision for the merger of the Industrial Finance Corporation with the bank or for the conversion of this Corporation into a wholly owned subsidiary of the Industrial Development Bank has already been made so that in case there is need for it, the provision might be implemented.

The Unit Trust of India

The Unit Trust of India, set up under the Unit Trust of India Act, 1963 started functioning from February 1, 1964. The initial capital of the Trust, Rs 5 crores, has been subscribed to by the Reserve Bank of India, the Life Insurance Corporation of India, the State Bank of India and its subsidiaries, Scheduled Banks and other specified institutions.[9] The Trust has also capital through sale of Units each of the face value of Rs 10. The price at which the Trust would be prepared to buy and sell such Units would be determined from day to day.

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9. R.B.I. Bulletin August, 1964, p. 1023.

The principal aim of the Unit Trust is to mobilise savings from even the Small Savers and channel them into productive investment. The small savers, it is hoped, would develop a sense of participation in the national endeavour while the ownership of industry would become more diffused and widespread than hitherto. In order to build up the small investors' confidence, the Trust would so balance its securities portfolio between fixed income-bearing securities and variable income-bearing securities, that risks of investment are minimised and a reasonable return on investments is assured. As a measure of inducement, it has been provided that income received by individuals from Unit certificates would be exempted from income-tax, if such income does not exceed Rs 1,000.

Special institutions for long-term finance, of the type India has set up in recent years, are useful so far as overcoming the finance bottleneck in economic development is concerned. For helping new industries and supporting new issues, they are particularly useful. But 'finance is, in fact, only one of the impediment to development, and often by no means the most important'.[10] Unless there is a real counterpart to that finance somewhere either currently or in the near future, long-term finance may prove inflationary. True that investment creates a real counterpart in the form of additional savings via additional real income but the time within which this would happen in the under-developed countries, with the deadweight of all those factors that are inhibiting development, would not be the same as in the developed

10. Factors in Economic Development: A.K. Cairncross, 1962, p. 159.

ones.

Therefore, in under-developed countries particularly deliberate and forced expansion of the capital market through special financial institutions should be attempted in terms of mobilised savings, of the people rather than in terms of subscriptions from the banking system. Yet in India, these institutions are leaning heavily on the support of the banking system. In the paid-up capital of Industrial Finance Corporation of India, the Reserve Bank's Share was 20 per cent while the share of the scheduled banks and cooperative banks was 25 per cent and 10 per cent respectively.[11] Out of Rs 35 millions contribution of Indian investors in the paid-up capital of the Industrial Credit and Investment Corporation of India, Indian banks and other financial institutions subscribed Rs 20 millions.[12] In the case of the Industrial Development Bank, the entire paid-up capital of Rs 10 crores would be a contribution from the Reserve Bank whereas in the paid-up capital of several other institutions of long-term finance, the Reserve Bank,[13] the State Bank and the Scheduled banks would be substantial

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11. The Monetary and Fiscal Policy of India; K.C. Chacko, 1957, p. 274.
12. op. cit., p. 282.
13. Reserve Bank of India and Industrial Finance

(Thousands of rupees)

As at the end of	Long-term Finance to Industrial Finance Corporation		State Financial Corporations	
	Shares	Bonds	Shares	Bonds
1950-51	102,70	[illegible]	[illegible]	-
1955-56	102,70	200,00	170,00	-
1960-61	102,70	200,00	235,00	-
1961-62	142,70	200,00	245,00	6,75
1962-63	142,70	220,00	243,00	18,75
1963-64	142,70	220,00	243,00	18,75

Note; From 1958-59 onwards, long-term finance to Refinance Corporation is Rs 100 lakhs in shares. This represents the paid-up value of the shares of Rs 5 crores taken up by the Bank

Source: Report on Currency and Finance for the year 1963-64, p. S55

contributors. The issue of financing long-term investments remains basically the same whether finance is indirectly channelled through special institutions or directly channelled through the banking system. May be that the contribution of banks in this finance is only a small proportion of the total fixed investment of the economy at present. But unless we show awareness of its implications from now, the trend may not be halted or reversed at all.*

Another aspect of the financing of long-term investments in India is related to the multiplicity of institutions supplying long-term finance for development.[14] We have ourselves mentioned as many as eight such institutions. One wonders if it would make any difference to their efficiency if we have reduced their number.

We should remember that almost all of India's institutions of long-term finance are under the direct or indirect control of the Government. In fact, 'if governments assume responsibility for drawing up, in some sense, development plans for their countries, the distribution of resources by development finance institutions can be in full harmony with these official plans

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* The loans sanctioned by special financial institutions have been rising rather rapidly. In 1962-63, the loans sanctioned by them (Industrial Finance Corporation of India, The Industrial Credit and Investment Corporation, the State Financial Corporations and The National Industrial Development Corporation) were Rs 54 crores; in 1963-64, they increased by about 30 per cent to Rs 70 crores. In the case of the Refinance Corporation for Industry, the loans sanctioned rose by 100% to Rs 23 crores in 1963-64 (R.B.I. Bulletin, August, 1964, p. 1015).

14. Carncross, op. cit., 170.

only if the institutions have clearly decided that the criteria to be adopted in deploying funds are those accepted by their governments rather than those which would arise from consideration of commercial profit and loss'.[15]

India is a much more thoroughly planned economy than many other under-developed countries. The situation here is, therefore, eminently suited to the making of long-term finance an integral part of her public debt policy. Instead of several institutions trying their hands at funds in the market at the same time, the Government itself should try to do that through an appropriate public debt policy. Funds borrowed by the Government (as far as possible only through non-institutional sources) should flow into what may be called the National Savings Corporation. As a counterpart to this institution, we might set up a National Investment Corporation with three branches dealing with large-scale industry, small-scale industry and agriculture separately.[16] This, one might say, would be a far simpler way of doing things and help impart a better sense of perspective to governmental policies than the present arrangements. The present arrangements only make for a lack of coordination between the savings and investments efforts of the economy, result in unbalanced growth and push-up the price-level.

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15. <u>Capital Funds in Under-developed Countries</u>: Edward Nevin, 1963, p. 78.
16. 'In general, it may be said that the balance of advantage will probably lie with a separation of the two functions of collecting investible funds, on the one hand, and their investment in specific enterprises, on the other, into two distinct institutions',
op. cit., p. 77.

CHAPTER 15

MONEY SUPPLY, NATIONAL INCOME AND PRICES

The view that a liberal money approach has permeated India's development efforts is confirmed by the behaviour of money supply vis-a-vis national income and by the rise in the general price index.

Money supply which was Rs 1,792.86 crores in 1951-52 almost doubled itself in 1963-64, the index rising from 102.1 in the former year to 191.3 in the latter. This gives us an annual average rate of growth of money supply since the beginning of First Plan which is only slightly less than 7.5 per cent. As against this the average annual rate of rise of wholesale prices during the same period would be about 3 per cent, the price index reaching the level of 135.5 in 1963-64 as against 99.4 which it was in 1951-52. In 1961-62 the index of national income was 137.1 whereas in 1951-52, it was 96.2. Thus for the period of the first two plans, national income rose at a rate which was much less than that of money supply, i.e., about 4 per cent per annum. For 1961-62 and 1962-63, this rate would be 2.4 per cent per annum only.[1] On the other hand since about the beginning of this year the indices of both money supply and wholesale prices have been indicating rates which are more than twice the average rates during the preceding twelve years.

Money Supply and Wholesale Prices

Year 1964	Money Supply with the Public		Whole sale price Index Base 1952-53 = 100
	Amount in crores of rupees	Index Base 1952-53= 100	
February	3,686	210.4	138.1
March	3,752	214.2	139.8
April	3,840	219.2	139.8
May	3,837	219.0	143.0
June	3,812	217.6	146.7
July	3,760	214.6	150.4

Source: R.B. Bulletin, August, 1964, pp. 1048, 1049.

1. Report on Currency and Finance, 1963-64, p. 47.

It is often suggested in India that the rate of rise of Indian prices is not very much greater than that of prices in many other countries. Perhaps Indian prices are not rising as rapidly as prices in Brazil or Argentina, but there is considerable difference between Indian prices and United States prices, for example, or between Indian prices and prices in West Germany, Italy, Japan, Netherlands, Pakistan, United Arabic Republic and United Kingdom. In most of these countries wholesale prices since 1960 have been rising at about 1 per cent per annum at the outside.[2] In fact the wholesale price index in the United States remained unchanged at 100 during all the years between 1960 and 1963. The wholesale price index in Japan was the same in the first quarter of 1963 (102) as it was in 1960 while the wholesale price index in United Arab Republic was only 1 per cent higher in the last quarter of 1962 as compared to that in 1960.

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2. From 1953 to 1959, prices in West Germany rose only by about 1 per cent a year; during the whole of this period, they showed a rise of a mere 2 per cent in Japan, whereas in Italy they actually declined by 1 per cent.

('Inflation Caused by Over-investment': B.R. Shenoy, Supplement to Capital of 20th December, 1962, p. 47).

There can therefore be no cause for smugness for Indian planners in so far as it is sought to be derived from international comparisons.

But there is another source of smugness which is born out of the assumption of a mythical norm for price rise in a developing economy. Provided prices in such an economy are not rising faster than 4 per cent or so, we have, it is suggested, no reason to cast doubts on the desirability of our fiscal or monetary policies.

It is difficult to understand the logic behind this assumption. If the idea were to be only that in the earlier stages of development, economic growth is bound to be unbalanced with the producers' goods sector getting more attention than the consumers' goods sector, one could understand it. But why should unbalanced growth which produces a less than 4 or 5 per cent rate of price rise be regarded with approbation and that which produces a higher rate of price rise be regarded - with disapprobation is not at all clear. Rising prices may or may not be inevitable in a developing economy but it is certainly too much to suggest that a particular rate of rise of prices is also inevitable. There seems to be no scientific basis behind the norm of a 4 to 5 per cent price rise nor is it, as we have just seen, corroborated by the experience of such developing economies as Italy, Japan and the United Arab Republic.

In fact in the matter of deciding a norm for price rise for a country, the experience of other countries may not be entirely relevant unless they are all having approximately the same levels of per capita income, same degree of inequality of incomes and

unemployment, same rates of population growth and the same type of social and political attitudes. A given rise in prices would, obviously, produce different impacts in different contexts. Where average incomes are high, where industrial employment is a far greater proportion of the total and trade unions are well-organised and where increase in wages and other incomes can, therefore, be more easily extracted, even a higher rate of price rise may not matter. On the other hand, where average incomes are close to minimum of subsistance and self-employment is predominant, where there is widespread unemployment and trade unions are weak because of competition amongst labourers in the labour market, even a slight rise in prices may cause considerable hardship to the people and become unbearable.

What is true of different countries may be true of the same country at different times. In particular, if the price rise norm is related to unbalanced growth, the same norm should not be appropriate for different phases of the growth endeavour, since the degree of unbalance which goes with the earlier phase of that endeavour would normally be greater than, and not the same as, that which goes with the later phases. At any rate, this should be so, if growth has been as properly planned as it is claimed to have been, in the Indian economy. Thus provided 4 to 5 per cent price rise is the assumed norm in respect of the First Five Year Plan, that for the Fourth Five Year Plan should be lower unless Indian Planners are planning for a growth which is always equally unbalanced.

One doubts, therefore, if there is or can be a non-inflationary price-rise norm which is valid for all countries and all

times. That growth in an under-developed economy may be unbalanced and prices may rise is true, but this can be no justification for any sense of complacency so far as efforts aimed at preventing a rise in prices are concerned. This needs to be mentioned since an assumed price-rise norm may be used to justify faulty economic policies. India's liberal money policy is a case in point.

Now, to suggest that prices must, as far as possible, be prevented from rising is easy, to think of the growth of money supply which can help us do that, extremely difficult.

An attempt at saying something about that growth was made towards the close of the Second Five Year Plan period when some economists of the Reserve Bank of India made calculations of the probable requirement of bank credit in the Indian economy during the Third Five Year Plan period.[3]

On the basis of the following assumptions:

(i) inventory investment is 64 per cent of the net fixed investment,

(ii) bank credit finances 65 per cent of inventory investment,

(iii) bank credit to non-corporate small scale industries is 10 per cent of the total credit to industry,

(iv) bank credit to industry is 65 per cent of the total bank credit,

(v) the term credit requirements of private organised industries is 5 per cent of their total net fixed investment, and

(vi) bank credit to public sector companies would increase by about Rs 50 crores,

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3. B.K. Madan, op. cit., pp. 247-258.

they concluded that 'total bank credit requirements .... during the Third Plan period would be around Rs 775 crores as against an increase in bank credit of about Rs 287 crores during the First Plan period and an estimated increase of about Rs 400 crores during the Second Plan period.'[4]

However, this estimate does not say what the increase in total money supply during the Third Plan period should be.

Further, it rests on the assumption of what is or has been rather than on what should be. Take, for instance, credit requirement for inventories. In an economy where growth is likely to be unbalanced and where pressure upon prices has, therefore, to be minimised, we may not only not accept the ratio of inventories to net fixed investment or to the value added, which has been prevalent in the recent past, we may have to think in terms of a reduced ratio.

It is said that 'according to a study made by Mr. H.K. Mazumdar and Mr. Morris J. Solomon in the Indian Statistical Institute, the ratio of total inventories held to the value added for all industries was, in 1955, 0.26 for the United States and 0.87 in India. For comparable industries in the two countries, they found the same order of difference. Thus, in enterprises producing paints and varnishes, the ratio was found to be 0.91 in India and 0.38 in the United States; in tanning, 2.18 in India and 0.49 in the United States; in Cement, 0.80 in India and 0.18 in the United States.'[5]

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4. op. cit., p. 251.
5. The Economic Times, October 8, 1964.

To plan money supply on the basis on such high inventory ratios would be to perpetuate the inflation which planned money supply is supposed to curb. On the other hand, to fix upon the right ratio of inventories to the value added may be difficult since it will have, amongst other things, to be related to the extent to which economic growth is planned to be unbalanced and there may be no easy method of measuring this unbalance. Whatever the difficulties, we have to try to fix a ratio for inventories which is consistent with our growth requirements before we plan a proper expansion of money supply.[6].

The difficulty regarding assessment of the demand for transactions balances is no less great. The position in respect of such balances is that the current supply of funds for transactions, which include payment of wages as well, is considered to be absolutely legitimate even if the producers concerned might have decided to offer very much higher wages to labour than hitherto. It is, of course, open to producers to raise money wages of labour and to occasion an expansion of money supply on that basis. Rise in wages of labour is an entirely desirable step also but it may result in demand for increased wages everywhere else in the econom

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6. A factor to be taken into account while planning growth of money supply is that of monetisation of the economy.
For the Indian economy, the rate of monetisation is supposed to be one per cent per annum.
(R.B.I. Bulletin, July 1961, p. 1046).
Since this factor is generally slow to change, it may have no particular significance. But the demand for money which this gives rise to has, of course, to be included in the amount by which money supply is to go up.

This would compel the monetary authorities to create even more money. And so in the matter of money supply, the monetary authorities would be forced to lose their initiative while chaotic wage behaviour results in a chaotic money creation.

Whatever applies to transactions balances relating to labour consumption would apply to the balances relating to the consumption of the entire economy. One has to concede that the behaviour of general consumption patterns in India since the First Plan has been no less chaotic. It could not be otherwise since we have no policy which aims directly at controlling consumption levels. The indirect taxes that we impose are primarily a revenue yielding rather than a consumption controlling device. As for income-tax, it was never meant to regulate consumption directly. It can only increase consumption and if it is steep and produces a disincentive effect on enterprise, it may push up consumption very considerably. Clearly if consumption is left to be determined by what one can buy in the market, an assessment of the demand for transactions balances satisfying consumption would be difficult. In any case money supply planned on the basis of consumption patterns as they are or have been in the recent past might perpetuate inflation in the same way in which money supply planned on the basis of actual inventory ratios would. Therefore, just as we have to fix upon inventory ratios which are consistent with our, growth requirements, we have to decide the economy's consumption patterns also. This, in other words, means that for a planning of money supply which helps price stability, rather than inflation, it is desirable to lay down national consumption policy. The task of determining consumption packets for various categories of people

is bound to be extremely difficult in the earlier stages, but until that is done, the initiative in the creation of transactions balances relating to consumption would be more with the market and less with the banking authorities. On the other hand, if the Central Bank has a definite idea of the consumption packets of different categories of people, it can decide, taking into account the current level of prices, the amount of money that is to be created as an addition to the 'wage fund'. With a national consumption policy, and with approximately as much addition to the wage fund as should go with it, planned money supply can help price stability much better than when a chaotic consumptions are free and behaving in a chaotic and unpredictable manner.[7]

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7. A national consumption policy is also needed to provide us with a right perspective in respect of our fiscal policies. If we know what consumption packets are to be given to different categories of people, we know how to approach them with measures which might leave them with no more income than is sufficient to buy those consumption packets. At the moment our tax measures are entirely arbitrary. We try to come down upon the consumption of those whose consumption packets are already smaller by the reason of their poverty and of rising prices. On the other hand, we find ourselves helpless to attack the consumption of those who are enjoying progressively rising consumption packets. If we have decided the approximate consumption packets for different categories of people, we would know how to proceed with our tax policies so that consumption is, at least approximately, kept within accepted limits.

   In so far as planning of consumption would enable the avoidance of leakages like conspicuous consumption, a rational consumption policy should help greater mobilisation of resources and accelerated economic development.

   That it will help in minimising the adverse impact of unbalanced growth is obvious. If the producers' goods sector is given higher priority and consumers' goods supply is unable to keep pace with it, planned consumption can be used for reducing the unbalance.

   See the author's article 'National Emergency and Our Tax Policies' in the <u>Leader</u>, March 3, 1963.

Thus understood 'financial planning', using it in a sense so to include planning of money supply also, would not assure price stability unless it is backed by suitable 'non-financial' policies. There would be agreement with Dr. Kalecki when he says that 'the problem of avoiding inflationary pressures in economic system is not "monetary" in character',[8] or with Professor Kahn when he suggests that 'no assurance of correct monetary policy can be derived from matching the expansion of the monetary medium with the growth in the use of money for the purposes of day-to-day transactions.'[9] However, if these remarks imply that money does not matter at all and that any quantity of money can go with a given increase in national income, it will be difficult to accept them. We might recall here with profit, the experience of one of the most thoroughly planned economies of the world, namely, the Soviet economy. Referring to the situation at the beginning of the First Five Year Plan, L.E. Hubbard observes, '..... Communist directors of State enterprises were too apt to think that maximum results at maximum speed were all that mattered. The facility with which credit was obtained from the Gosbank encouraged the belief that money was of secondary importance because the State could create unlimited quantities at practically no cost to itself'.[10];

8. 'An Outline of Financial Policy', Economic Strategy and the Third Plan, I.S.I. 1963, p. 63.
9. 'The Pace of Development', The Challenge of Development, Jerusalem, 1957, p. 185.
10. Soviet Money and Finance, 1936, p. 230.

consequently 'Enterprises which should have maintained their turnover capital intact and liquid found that they could get practically an unlimited amount of credit and because the rouble was patently a depreciating currency and had begun to lose its reputation as a stable medium of exchange, there was a flight into goods. Enterprises began to use their own turnover capital and not infrequently borrowed capital as well for increasing their fixed capital or for accumulating stocks of liquid capital in the form of material and goods. In such circumstances, the incentive to make money profits was weakened, production costs rose and there appeared many symptoms of inflation'.[11] According to Hubbard, it was on account of experiences such as this, that the Soviet Government decided that 'the future economic development of the country demanded a more orthodox monetary policy'[12] and 'the Gosbank took over the task of regulating prices by means of a managed currency'.[13]

It would not be convincing, therefore, to suggest that in relation to the price level money supply in a planned economy is an entirely irrelevant factor.

If we remember now our main argument against a liberal money policy, namely, that finance, in an over populated under-developed economy like ours, can be no substitute for real capital, we get the following approximate guide lines for a monetary policy which can be consistent with the requirement of growth with stability:

(i) the rate of interest should reflect the fact of real

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11. op. cit., pp. 225, 226.
12. op. cit., p. 247.
13. op. cit., p. 233.

capital scarcity;

(ii) money supply increases should, as far as possible, not have anything to do with fixed investment which should be the concern of the saving and taxation institutions;

(iii) the banking system itself should be responsible for the needs of the working balances of the economy;

(iv) advance estimates of such balances should be made so that there is no unplanned expansion of money supply;

(v) since planned money supply would have to rest on the assumption of some 'non-financial' policies, the Government should not only be clear and categorical about those policies, it should be prepared to apply proper measures to implement them.

Will there be assurance that with commercial banks in the private sector, it will be possible to control money supply expansion in terms of the planned amounts?

We have already referred to the possibility of increased time-deposits creating conditions for an expansion of money supply which might be far greater than what has retired into the banks in the form of those deposits. As long as it is profitable for the banks to create money and for the borrowers to use it, indirect measures of credit control may not be effective.

The data for 1963 available in respect of 29 larger Indian Scheduled banks show an increase in the balance of profit after taxation from Rs 10.6 crores in 1962 to Rs 11.5 crores or by 8.5 per cent.[14] In view of the fact that the rise in profits was mainly due to higher earnings on advances following the step up in

14. R.B.I. Bulletin, April 1964, p. 458.

lending rates that year, the profits in 1964 should be even higher since the lending rates have been stepped up still further this year.[15]

With money creation being a profitable business, it was natural for the average level of scheduled bank credit during 1963 to be 9 per cent higher than that of 1962.[16] In fact throughout this period since 1955-56, bank credit has been rising at a rapid rate. The total bank credit which was about Rs 770 crores at the end of 1955-56 nearly doubled itself by 1960-61 to Rs 1335 crores and touched at the end of 1963-64, an all time high of nearly Rs 1820 crores.[17]

One way of dealing with the situation is to fix a ceiling on bank profits so that the lender-borrower conspiracy which is the principal obstacle to an effective credit control is broken. Howsoever valuable the profit principle might be in the sphere of commodity or capital goods production, it is a little difficult to appreciate it in the sphere where money is produced. For free economies perhaps, the principle itself is more important than the sphere in which it is applied. Moreover, neither their financial nor real pòise is sought to be determined through a Planning Commission. India's case is obviously different, and therefore a ceiling on bank profits can be safely applied here.

But the best way of assuring planned increases in money supply would be to disallowed banks from functioning in the private sector. The principal consideration in the controversy relating to nationalisation of commercial banks in India should

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15. The Financial Express, September 27, 1964.
16. R.B.I. Bulletin, April 1964, p. 458.
17. The Economic Times, October 8, 1961.

neither be the amount of profit the Government would bag in by taking over these institutions, nor the value of compensation whose payment, in any case, can be extended over a conveniently long period of time. It is the ease or the facility with which the creation of the right amount of money can be planned alongside with the creation of goods in the country. Private banks would, generally, come in the way of this facility.

After all, private entrepreneurs in India have a very vast field of endeavour[18] open to them. If banks are nationalised, they will still have a considerable field in which to try their entrepreneurial abilities. Unless they have a fear that bank nationalisation would reduce their hold on the Indian economy and their monopolistic power,[19] there is no reason why they should be opposed to it. As for the argument that nationalisation of banks would hamper growth in the private sector, it is no more valid than the argument that the control of foreign exchange or steel would hamper such growth. Finance is only one of the many vital resources available to the economy. If cement and Steel can always be available for legitimate purposes, why cannot finance? And in any case, where is the point in having too much finance, when too little Steel or too little Cement is available?

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18. According to the Industrial Policy Resolution of April, 1956, the future development of industries like cement, sugar, tea, cotton and jute textiles, to mention only a few will be left to the initiative and enterprise of the private sector.
19. Iengar, op. cit., p. 149.

The hitch over nationalisation of commercial banking in India becomes more un-understandable when it is remembered that the biggest the most efficient commercial bank in the country namely the Imperial Bank of India has already been nationalised. To quote from a tribute paid to the bank much before its nationalisation, 'As far as the business of conducting commercial banking is concerned, the Imperial Bank is the pioneer if not the model for the rest of the Indian banking System'.[20] At the time of nationalisation,[21] the deposits of the Imperial Bank of India were 21.3 per cent of the total deposits of all the scheduled and non-scheduled banks and a little less than 28 per cent of the total deposits of all the scheduled banks in the country.[22]

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20. The Eastern Economist, March 1, 1946, p. 333.
21. Imperial Bank in relation to other major Banks as of 1953

(in millions of rupees)

	Capital & Reserves	Total Deposits	Total Investments	Loans & Advances
Imperial Bank	119	2,069	941	920
Reserve Bank of India	100	2,470	798	242
Foreign Scheduled Banks (16 Banks)	N.A.	1,659	469	1,015
All Indian Scheduled Banks (72 banks and excluding Imperial Bank)	474	5,330	2,346	2,447

Quoted in the Monetary and Fiscal Policy of India: K.C. Chacko, p. 75.

22. Chacko, op. cit., p. 66.

The thing is that if money supply increases in India are to occur as they might be planned, methods stronger than the usual credit controls have to be thought of.

It can be argued that changes in the velocity of circulation of money or in the rate of turnover of demand deposits may neutralise the advantage of a planned money supply.

Rate of turnover of Deposits of Scheduled Banks

	Rate of turnover of current deposits		Overall rate of turnover	
	of business and individuals	Total*	of business and individuals	Total*
1950-51	36.1	33.9	..	14.3
1955-56	46.9	45.0	17.4	17.1
1956-57	48.6	45.9	17.1	16.9
1957-58	50.2	45.3	17.0	16.6
1958-59(1)	39.6	36.2	17.9	17.4
1959-60	40.6	38.1	17.3	17.1
1960-61	44.3	41.8	18.1	17.8
January 1961	47.2	44.6	19.5	19.4
February 1961	42.8	40.6	17.0	16.9
March 1961	53.1	48.8	20.0	19.6
April 1961	49.3	46.5	18.5	18.2
May 1961	47.3	44.4	17.6	17.3
June 1961	43.1	41.1	17.3	17.0
July 1961	46.9	44.8	18.0	17.8
August 1961	43.5	41.3	16.0	15.9
September 1961	48.0	45.6	17.8	17.7
October 1961	44.5	41.4	16.6	16.3
November 1961	46.9	43.9	17.3	17.1
December 1961	49.7	47.3	18.7	18.6

* Includes data relating to Government and Quasi-Government bodies and business and individuals.

(1) From 1958-59 onwards, the turnover of current deposits is calculated by dividing debits to current account during the year by the monthly average of current deposits. The overall rate of turnover is aimed at by dividing debits to current account and cash credit and overdrafts by the average outstanding of current account and the effective cash credit and overdraft limit. Data for the years before 1958-59 are not comparable with data on and after that date, because the basis of calculation has been changed.

Source: Report on Currency and Finance, 1962-63, p. S 33.

The argument is valid. But there are three points which may be made.

First, the increased velocity of money may itself be the consequence of an unplanned money supply: Once unplanned creation of money has raised prices, 'expectations of rising prices may increase current expenditure and thereby step up the velocity of circulation of money......'[23] It is significant that between 1958-59 and 1960-61 when the annual rate of turnover of demand deposits in India increased from 39.6 to 44.3, the consumer price index and the whole sale index also showed a rise. The former rose from 118 to 124 (base year 1949 = 100) while the latter from 112.1 to 127.5 (base year 1952-53 = 100).[24]

Thus in so far as changes in velocity of circulation result from a lack of planned creation of money, they would be taken care of once increases in money supply begin to be properly planned.

Secondly, as we have already suggested, unless financial planning is backed by action on the 'non-financial' plane, such planning may not be able to restrain inflationary pressures. This implies that the flow of expenditure is regulated from all possible directions. A national consumption policy would, of course, provide the base for an attack but physical control and taxation would have to carry it out. Perhaps we may have to think of a deterrent tax on inventory accumulation, conspicuous consumption, unproduc-

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23. 'Analysis of Money Supply in India', R.B.I. Bulletin, July, 1961, p. 1045.
24. 'Growth of Bank Deposits Lags Behind Demand for Credit'; R.M. Mitra, Supplement to "Capital" of 20th December, 1962, p. 101.

tive investment and the construction of luxury apartments.[25] Without such actions, planned money supply would be ineffective but with the help of such actions and with money supply planned, expenditure may be so controlled that velocity of circulation ceases to be a problem.

The third point bearing on the issue is simple. Assuming that velocity remains a problem, how does that go against the desirability of planning money supply, since without such planning, the inflationary impact upon prices may be doubled?

An important qualitative change which planning in India needs is a clearer bifurcation between physical and financial planning. This might require working in terms of real input-output tables which in the present state of the India's economy, including, of course, the sorry state of her statistics, may not be easily possible. But until that is done, unbalances resulting in a price rise may be unavoidable. In any case, India's financial planning must try to make an assessment of the working money balances which the economy would require with the growth of its real income. May be that this assessment is a mere guess work in the earlier stages. But it is not convincing to avoid good policies on the plea of a disappointing beginning.

25. Kalecki, op. cit., p. 61.

MONETARY POLICY AND THE AGRICULTURAL SECTOR

CHAPTER 16

AN ANALYSIS OF DEMAND FOR MONEY AND INTEREST RATES

On the theoretical plane, it appears desirable to break monetary analysis of an under-developed country like India into two parts: one general and the other specific, relating to the agricultural sector.

The reason for such break-up is the obviously dualistic character of the Indian economy. The difference in the degrees of development of these two sectors, in the socio-economic conditions and the attitude of the people are such as to make a generalised 'macro' study of the entire economy difficult and even disappointing. In the sphere of monetary theory, for example, the motivations determining the demand for money in the industrial sector may be different from those determining that demand in the agricultural sector. Therefore, whereas the rate of interest in the industrial sector might, as some have suggested, fluctuate because of fluctuations in the speculative motive directed towards bonds and other interest and profit bearing assets, in the agricultural sector, rate of interest cannot be explained in these terms; at any rate it cannot be explained only in these terms. One may have to think in terms of the demand for transactions balances vis-a-vis their supply coming from the well to do sections of the rural community.

Is the demand for transactions balances in the rural sector likely to be so formidable as to merit a serious consideration, since rural business is often reported to be transacted in kind rather than in cash?

The following figures throw some light on the question.

Value of Home-Produce Consumed as per cent of Consumer Expenditure

Monthly household expenditure groups	1953-54			1958-59		
Rs	Rural	Urban	All India	Rural	Urban	All India
1 - 50	49	18	45	46	10	40
51 - 100	48	10	41	43	8	35
101 - 150	45	9	38	42	7	33
151 - 300	44	8	36	41	7	31
301 & above	38	8	28	33	5	23
All household	44	9	37	41	7	32

Source: Incidence of Indirect Taxation, 1958-59, Tax Research Unit, Ministry of Finance, Government of India, New Delhi, 1961, p. 11, quoted by S. Ghosh in Monetisation of an Economy, p. 28.

In all income brackets, the monetised part of consumption expenditure in rural areas is less than that in urban areas. But in rural areas also, it is not as low as might be imagined.

In the second round (April - June, 1951) of the National Sample Survey, it was suggested that about 62% of rural consumption expenditure was in terms of cash. In the third round (August - November, 1951) of the Survey, the cash purchase of consumption was suggested to be 57% of the total value of consumption. The fourth round (April - September, 1952) of the Survey suggested

56% which was almost the same as the figure coming out of the third Survey.

That the demand for cash in rural areas is not negligible is suggested by another fact or also a good proportion of farm expenditure is in cash rather than in kind.

Cash Farm Expenditure : Regional Data - All Cultivators

(Intensive enquiry data)

Region	Total farm expenditure per family (Rs)	Total cash farm expenditure	
		Amount per family (Rs)	Proportion to total expenditure (per cent)
	1	2	3
1. Assam-Bengal	346	134	38.7
2. Bihar-Bengal	483	275	57.1
3. Eastern U.P.	271	129	47.5
4. Western U.P.	459	238	51.9
5. Punjab-Pepsu	677	332	49.0
6. Rajasthan	329	221	67.0
7. Central India	446	191	42.8
8. Orissa and East M.P.	268	111	41.5
9. Western Cotton Region	812	556	68.4
10. North Deccan	717	410	57.2
11. South Deccan	854	591	69.2
12. East Coast	592	369	62.3
13. West Coast	485	352	72.5
All India	495	282	57.0

Source: All India Rural Credit Survey Report.

In some cases, cash farm expenditure forms a very high proportion of the total as, for example in West Coast where it is as high as 72.5%, in South Deccan where it is 69.2%, in Western Cotton region where it is 68.4% in Rajasthan where it is 67% and in East Coast where it is 62.3%.

Consumption and production expenses put together the ratio of cash expenditure to total outlay is close to 60%.[1] Therefore, we cannot regard demand for money in the rural sector as being unimportant.

In order to be able to understand the suggestion that motivations behind the demand for money in the rural and urban sectors may be different, we might examine in detail the asset preference of the rural population so that we can put rural demand for money including asset demand in its proper perspective.

To begin with, we might consider people's attitude towards gold and the effect which preference for this asset has upon other asset preferences and upon the rate of interest in the rural areas.

Assets of gold holding in India range roughly between $ 3,675 - $ 6,300 millions (at the official exchange rate, Rs 4.75 equal $ 1.00). Prof. Brahmanand estimates gold holding in India at Rs 13 billions.[2] The Reserve Bank of India has estimated that 105 million ounces of gold accumulated in India between 1942 and 1957. The estimate for silver in 1957 was 4,235 million ounces.

The estimates for smuggled gold imports are of the order of Rs 65 millions per year which is any thing between 1 to 2% approximately of the total guess about the stock of gold in the country.

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1. Monetisation of an Economy by S. Ghosh, p. 30.
2. The Free Press, October 31, 1960.

with rigorous exchange control, we may assume this inflow from abroad to be almost ineffective in making any substantial change in that stock. So that gold prices would be changed entirely with the change in the internal production of gold and internal demand for it. If the internal production is also making a very negligible difference to the total supply, they may be changing on account of change in the demand for gold only.

Gold Production in India

		In Thousands of fine ounces
Year		Production
1958	..	170
1959	..	165
1960	..	161
1961	..	157
1962	..	163*
1963	..	160*

* Estimated or provisional figure

Source: Reserve Bank of India Bulletin, May 1964, p. 645.

A glance at the above table suggests that gold production in India has gone down by 10,000 fine ounces of gold between 1958 and 1963. Whereas in 1958, the production of gold was estimated to be 170,000 fine ounces, in 1963, it was estimated to be only 160,000 fine ounces. Even the production in 1962 was higher than that in 1963 by 3,000 of fine ounces. Thus the supply factor in the consideration of gold prices can be taken to be either constant or under-going a slight reduction over the years. There is a possibility that supply of smuggled gold might have increased but one doubts if the increase would be so considerable as to make a substantial difference to gold supply in the country. The explanation of changes in gold prices, therefore, should be found in

the behaviour of demand for gold.

What are the motivations behind the demand for gold?

(a) Gold may be wanted as a durable consumer good.

(b) Gold may be wanted as a form of holding one's wealth.

It may be difficult to draw a precise dividing line between these two motivations. We can regard gold as one amongst many other assets such as tangible investment goods, financial assets and money. The holding of such assets including gold can be analysed in terms of the particular asset's characteristics of risk, yield and liquidity.

In calculating the yield from gold, we may consider the psychic satisfaction obtained from being in possession of it and the capital gain resulting from an upward movement of gold prices as making for a positive yield. The storage, the depreciation and related costs in holding and transferring gold and the capital loss arising out of reduction in prices would make for a negative yield. In holding gold, there is a definite loss of interest which can be earned by holding such wealth assets as Savings Deposits, Defence Bonds, promissory notes or even oral promises of the borrowers entered by the lenders in their own handwriting in their account books.

There is one loss which holders of gold in the form of ornaments suffer and this should also be taken into account. Cost of converting gold bullion into gold ornaments - simple bangles and other pieces of jewellery can be made for payment of 5 to 10% of the value of gold being fabricated. In assessing the liquidity of gold, this cost has to be subtracted from total yield obtainable from gold held in the form of ornaments since gold merchants prefer

to impress upon the needy seller of used gold ornaments that they would melt down the ornaments to get gold bullion which they would further use for making other ornaments. It may be mentioned here in passing that the rate of profit on purchase of used gold ornaments is much higher than the rate of profit on the sale of the new ones.

The risk attached to gold as an asset arises from the possibility of pilferage. Other assets except cash would be much better from this point of view.

However, an analysis of the demand for gold, strictly on these lines, would suggest that this demand would fluctuate according to changes in the relative advantages from all the various kinds of a assets that are available to the agriculturists. But in point of fact what is to be seen is an almost exclusive attachment to gold irrespective of whatever might be happening to the advantages and disadvantages from other assets. This can be interpreted to mean that advantage from gold is much too big as compared to the advantages from other assets; it can also be interpreted to mean that people have such an emotional and extra-rational attachment to gold that it may not be useful casting their preference for gold into any rational mould of economic analysis. There is no doubt that people in rural India are not entirely rational in their preference so that part of the high premium on gold assets has just to be assumed and not explained. But the other part can have an economic explanation since the agriculturist is not an altogether irrational person.

What is the explanation? It appears that the agriculturists, particularly the poor agriculturists, who constitute an overwhelm-

ing proportion of the rural population, are driven both by the reason of their poverty and also of the uncertain nature of their incomes to hold assets largely as a precaution against the rainy day. In technical economic jargon, they are more actuated by the precautionary motive and less by the speculative motive. In the precautionary motive, considerations relating to yield are not unimportant. But the most dominating consideration is security, not maximisation of net advantage from holding wealth. Land, cash, cattle and house-hold effects like utensils are all alternatives to gold but they are not as dependable as gold is. Land has complications because of the difficulty of establishing legally qualifying title to it in many cases; cattle and house-hold effects are neither entirely liquid nor free from the fear of debasement. Currency is risky in the sense that it cannot be kept on the person all the time whereas gold can be.

The reason for the continued rise in gold prices does not lie in 'considerable income elasticity of demand (for gold) in the upward direction',[3] it lies in the continued poverty of the average agriculturist and the continued uncertainty of agricultural operations. In fact, one may even hope that in the distant future when the income of the average agriculturist has gone above the poverty barrier and agriculture has become more immune from the vagaries of the weather, the rise in the demand for gold might be no more a possibility than a fall in the demand for it. Gold would then be demanded after fully weighing the pros and cons of holding other forms of wealth. And in this evaluation, there is as much a possi-

3. 'Mobilisation of Private Gold Holdings', Hugh T. Patrick, <u>Indian Economic Journal</u>, October-December, 1963, p. 182.

bility that demand for gold would increase as that it would decline. And if that happened with rising income above the poverty barrier, it would obviously be very different from the fact of 'considerable elasticity of demand for gold in the upward direction'.

An idea of the poverty of the vast masses of agricultural population can be had from the following table:

Annual Income in Different Income brackets : 1959 All-India (Rural Areas)

Monthly Household income (Rs)	No. of sample house holds	Percentage distribution of households	Total No. of households (millions)	Total income (Millions)	Distribution of income
1 - 50	413	22.7	15.4360	1680.80	4.7
51 - 100	709	39.0	26.5200	23868.00	24.4
101 - 200	438	24.1	16.3880	29498.40	30.2
201 - 300	154	8.5	5.7800	17340.00	17.7
301 - 400	43	2.4	1.6320	6854.40	7.0
401 - 500	27	1.5	1.0200	5508.00	5.6
501 - 600	11	0.6	0.4080	2692.80	2.8
601 - 700	7	0.4	0.2720	2121.60	2.2
701 and above	16	0.8	0.5440	5222.40	5.4
All classes	1818	100.0	68.0000	97736.40	100.0

Source: Monthly Public Opinion Surveys of the Indian Institute of Public Opinion, Vol. V, Nos. 9,10,11, June, July, August, 1960.

Total Cash Receipts of the Small Cultivators

District	Total cash receipts per family (Rs)	Receipts from sale of crops and fodder as % of total cash receipts	Average amount borrowed per family (Rs)
Follow-up Survey, 1957-58			
Sorath	828	70	395
Akola	489	44	46
Gingleput	189	14	80
Nizambabad	215	9	91
Bnagalore	200	17	110
Quilon	296	6	61
Sagar	220	10	126
Jullundur	780	30	163
Deoria	305	15	87
Monghyr	567	7	84
Burdwan	463	10	79
Jaipur	472	4	194
Follow-up Survey, 1958-59			
Jalpaiguri	450	43	48
Mirzapur	142	10	97
Hissar	886	63	328
Ahmedabad	645	50	240
Cuddapath	279	27	118
Follow-up Survey, 1959-60			
Mindapore	560	50	126
Bhagalpur	544	8	51
Kanpur	281	22	185
Mohinderagarh	579	7	320
Barmer	177	43	55
Bilaspur	202	3	14
Tanjore	329	21	109
Krishna	262	15	85
Bijapur	258	25	145

Source: 'Provision of credit to Small Farmers'; H.B. Shivamaggi, Indian Journal of Agricultural Economics, July - September, 1963, p. 35.

While these data do not throw light on the behaviour of cash receipts of farmers of the same area over time, they do show that in general a farmer's cash receipts were high as compared to his borrowings.

The point being made here is not that the real demand for gold might not have arisen at all. But that this rise wherever it occurred might have been more prompted by either a desire for security if real income of the farmers was falling or the uncertainty of agricultural operations was increasing or if neither of these was happening, by consideration of relative advantage of different forms of assets desired by such of the agriculturists as had crossed the poverty barrier.

A study of the National Council of Applied Economic Research says: 'the rural households rather than urban households appear to account for practically the entire amount of gold and silver absorbed in the economy in recent years. This was of the order of Rs 39 crores in 1962'.[4] The details of the Survey are not yet available, but it will be difficult to suggest that this additional demand was from the side of the poor farmers or the even poorer lot of the landless labourers.

With a given per capita income of such farmers or such labourers; also with given degree of uncertainty of agricultural operations, the poor farmers' demand for gold can rise with increasing population because every additional son* in the family means requirement of so much more gold for ornaments for the daughter-in-law at the time of marriage.

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4. Rural Household Saving Survey, 1962 (Summary Statement), p. 4.

* Daughters are also cause for gold and silver demand at marriage time.

Expenditure on Marriage and other Ceremonies as a percentage of total Expenditure:-

District		
Burdwan	..	17
Monghyr	..	22
Deoria	..	36
Jullundar	..	35
Sagar	..	36
Surath	..	20
Akola	..	21
Nizamabad	..	16
Bangalore	..	25
Chingleput	..	29
Quilon	..	17

Source: Rural Credit Follow-up Survey, 1957-58, p. 74.

It can be seen from the above table that marriage and ceremonial expenses have accounted for as much as 36% of the total expenditure in Deoria and Sagar.

The relationship between the size of the family and the demand for gold is not fixed or invariable. In the first place, all daughters-in-law may not be given the same value of ornaments. Often the practice is that some of the ornaments of the bridegoom's mother or his sister-in-law who is already married, are used as a fake gift for the in-coming bridgs and then returned to the original owners. Often a father of four sons is unable to do as much for the three younger sons as for the eldest one. And so on. But there is no doubt that rising population leading to a larger number of marriages results in a rising demand for gold. This demand which we may call marriage demand for gold is income elastic in the sense that with higher income, parents like to give more gold to their daughters-in-law at marriage time. But for poorer farmers, the explanation for increased demand lies more in a rise of population than in a rise of income, since their income might

not have risen by any more than a negligible rate. For poorer farmers, therefore, the demand for gold is population elastic rather than income elastic. In fact, rising population, by keeping them below the poverty barrier, increases the security demand for gold as well. Thus while an under-developed economy may be having a speculative demand for gold, the demand emanating from bulk of the people in the rural sector is made up primarily of the security and the marriage demand rather than speculative demand. As long as population is rising at a rate which leaves them with negligible rate of rise of real income, and results in larger number of marriage through time, demand for gold would continue to rise to satisfy precautionary and marriage motives. Gold prices would rise not because income is rising but because income is not rising at all or rising so slowly that people see no chance of crossing the poverty barrier.

With such demand for gold being there, money supply over and above what the farmers require for transactions relating to industrial goods (they always buy a few industrial goods) is likely to get spilt over to the purchase of gold and raise gold prices.

One should think that the transactions demand for money of the rural sector is not as uniquely a function of the level of income as the transactions demand for money in a Keyensian type economy. For here, a given income (output) in the agricultural sector does not mean unchanging prices of industrial goods. Industrial goods prices are partly a function of income produced in the industrial sector also. It is possible for agricultural out-put to be the same and yet for the transactions demand of the agricultural sector for money to rise because of the rise in the

prices of industrial goods.

A broad idea of the rural sector's expenses on industrial goods can be had from the following data relating to the family expenditure of cultivators:

Expenditure on each item as percentage of total expenditure

District	Construction and repair of houses	Purchase of clothes	Marriage and other ceremonies	Medical purposes	Education
Burdwan	22	23	17	18	10
Monghyr	14	33	22	9	8
Deoria	20	19	36	6	4
Jullundur	24	22	35	7	6
Sagar	12	27	36	12	4
Surath	35	30	20	5	2
Akola	10	41	21	16	5
Nizamabad	20	45	16	8	4
Bangalore	14	38	25	8	8
Chingleput	19	32	29	10	5
Quilon	22	27	17	16	12

Source: Rural Credit Follow-up Survey, 1957-58, p. 74.

The expenditure on clothes is almost entirely an expenditure on Industrial Consumer's goods, that on marriage and medical purposes is also an expenditure on industrial consumer's goods to a very considerable extent. Expenses on books, stationery etc. (under Education) largely go to the Industrial sector. However in Construction, the industrial sector may not be a participant unless

there is a high demand for Cement, Steel etc. But in rural areas construction is generally done with the help of locally available materials.

Thus in so far as increased money supply in the industrial sector raises industrial prices, it can be a cause for increased transactions demand for money in the agricultural sector. Likewise diminishing return in the industrial sector leading to higher marginal cost and higher prices can also be a cause for increased transactions demand for money in that sector.

Another important factor influencing this demand would be the marketable surplus of agriculture. Other things remaining the same, the greater the surplus, the greater the amount of industrial goods the agricultural sector would be interested in and, therefore, the greater would be the transactions demand of the latter for money. If industrial goods prices are frising along with the rising surplus, the transactions demand for money will be even larger. On the other hand, if, starting with a certain situation, the prices fall faster than the surplus is rising, this demand would be smaller and so on.

The marketable surplus in agriculture is not quite a function of the level of income though income would be the most important single factor behind it. When population increases, the amount of food retained for self-consumption increases too. This would reduce marketabele surplus even when income is the same. Again when population is rising faster than output marketable surplus may decline even though income has risen. The factor of uncertainty of agricultural operations would add to the demand for retained stock and reduce the marketable surplus, but rising income itself is likely

to reduce uncertainty after a certain time.

The relationship between transactions demand for money in the rural sector and the level of its income is, therefore, not very invariable. On the other hand, it might be more correct to say that in the agricultural sector, the transactions demand for money is determined both by rates of growth of population and by the rate of growth of agricultural production.

The fact of industrial goods prices, which has already been mentioned, together with the rates of growth of population and agricultural out-put would thus set the tone for the behaviour of the transactions demand for money in the agricultural sector.

Now from the point of view of the analysis of the impact of increased money supply in this sector, it may be useful to remember that the motivations in between the small cultivators who constitute an overwhelming proportion of rural population and the big ones are more or less as different from each other as the motivations in between the industrial and the agricultural sectors. The reason why it is important to remember this is that with such differences, the behaviour of all the various groups of recipients of money supply, when they happen to be in possession of an increased or decreased stock of money, would not be the same. Some would aim at assets assuring security whereas others at those assuring maximum return; in the case of some, extra money would go into acquiring gold; in the case of others it may go into acquiring financial assets of various kinds. It is clear that if the direction of extra money is gold, the impact of that money on prices, production and employment would be of one sort, if its direction is financial assets, it would be of another; if extra money is going into land

and cattle, the impact might be some thing else. And so on.

National Council of Applied Economic Research suggests a figure of ₹ 179 crores for the net change (increase minus decrease) in the financial assets of the rural sector in India.[5] It includes (a) commercial and co-operative bank deposits, ₹ 19 crores; (b) small savings, ₹ 33 crores; (c) life insurance premium, ₹ 22 crores; (d) provident fund, ₹ 16 crores; (e) cooperative shares and other securities, ₹ 10 crores; (f) chit fund etc., ₹ 9 crores and (g) change in currency and coins, ₹ 70 crores.[6] Excluding ₹ 70 crores for currency and coins, the financial assets come to ₹ 109 crores. The reason why we might exclude currency and coins is that the cash in hand does not necessarily mean savings. Moreover, the Survey has only speculated on the amount of financial assets in the form of currency and notes; it has not found it out through investigation. This is not to deny that some people in the rural areas might be holding cash as an asset; but half the total change in currency seems much too big a proportion to hold in that form.

As has been stated above, the demand function for money for the small cultivators is not quite the same as that of big ones. However, it may not be easy to talk of the values (prices, production etc) determined by the small cultivators' demand function for money and the quantity of money and those determined by the big cultivators' demand and supply functions of money because while demand for money can somehow be concretised separately (though that too is difficult) supply of money available to the smaller culti-

5. Op. cit., p. 4.
6. Ibid. The data on currency and coins, according to the NCAER summary of this Survey, were not canvassed in the Survey in view of household reluctance to give such information but saving in this form was roughly estimated on the basis of external data at ₹ 70 crores (about 50% of the total change in currency in 1962).

vators in the rural sector is a difficult question to answer. The truth of the matter is that the stock of money in the rural sector is one pool from which both the groups can draw; it is difficult to divide this pool into two exclusive portions.

Can the stock of money in the entire economy be broken up into exclusive parts operating in the industrial and rural sectors? In other words, can we say precisely what the quantity of money in the industrial and the agricultural sectors respectively is? In view of the fact that bank money is just a small proportion of the money supply in the rural sector, we may assume such a break up for our analysis here.

Borrowing from Commercial Banks - All India Data

	Borrowing from Commercial Banks as percentage of total borrowing	Proportion of families borrowing from commercial banks (per cent)	Average borrowing from commercial banks per family from commercial bank borrowing
Big cultivators	1.9	0.6	1,612
Large cultivators	1.4	0.5	1,003
Medium cultivators	0.5	0.3	275
Small cultivators	0.4	0.2	179

Source: All India Rural Credit Survey Report, 1957.

In the case of small cultivators, the percentage of total borrowing from the commercial banks is 1/5th of 1% only. If we consider all families and not only those borrowing from commercial bank, the average amount of money borrowed per family is a mere Rs 1.8. The position in regard to non-cultivators is even worse,

because in their case the average per family borrowing from commercial banks is Rs 1.3 only. While there has been some additional monetisation of the Indian economy since the Survey, there is no reason to think that the percentages have so radically improved that commercial banks can be taken to be an important influence on money supply in the rural sector.

The advances made by the State Bank of India, which was set up as a substitute for the nationalised Imperial Bank of India to the cooperative banks can make a difference to the money supply in the rural sector. From Rs 8.5 crores granted as on September 30, 1957, the State Bank of India's loan limit for cooperative banks rose by 40% to Rs 11.4 crores as on 31st May, 1961. As an absolute amount it is too insignificant at present to produce an adequate impact upon money supply in the rural sector. However, with the Reserve Bank's encouragement in respect of the opening of new branches, the State Bank promises to play an important part in the regulation of money supply in that sector.

The Reserve Bank of India itself can be a source of direct impact upon that money supply because of its interest in cooperative credit. If we examine the amount of short-term loans, given by the Reserve Bank for seasonal agricultural operations, we will see that whereas in 1948-49 (year July - June) the amount sanctioned was Rs 180.25 lakhs, in 1958-59, it was Rs 6,542.44 lakhs.[7] In fact, the amount of loans has been rising continuously since that time.

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7. R.R. Kale Memorial Lecture by Sri B. Venkatappiah, Deputy Governor, Reserve Bank of India, delivered at Poona on April 16, 1960.

Year (July-June)	Rs lakhs Increase in loans over the level of the previous year
1949-50	33.75
1950-51	548.00
1951-52	478.00
1952-53	2.39
1953-54	389.76
1954-55	488.40
1955-56	842.95
1956-57	561.50
1957-58	1299.33
1958-59	915.74

Referring to this impact, the Deputy Governor of the Reserve Bank of India said, '...... there are issues more immediately connected with the role of the Reserve Bank in rural credit. One of these is the question of the possibility of the inflationary pressure in the economy being increased as a result of rapid expansion of cooperative credit based on a large part, on loans obtained from the Reserve Bank.'[8]

Thus the Reserve Bank credit to the rural sector can be an important source of money supply to that sector.

To come back to the earlier point then, we can at any rate loosely regard money supply in the rural sector as an entity which is at the moment separable from the quantity of money available to the industrial sector. In particular, we can talk in terms of money supply in the rural sector rising even when that in the industrial

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8. Ibid.

sector is not rising or vice versa. From the analytical point of view, our inability to make a clear cut assessment of the stock of money in t e rural sector at any given time need not detain us as long as we know how this stock changes over time. With a rough idea of the demand function for money of the two broad groups of rural population and the factors which would change the stock of money in the rural sector, we may have a proper angle to view money in the rural sector from.

Now, what changes the stock of money in the rural sector? One factor evidently is the behaviour of the expenditure of the industrial sector on agricultural commodities (we assume that no agricultural goods are imported from abroad) and of the expenditure* of the agricultural sector on industrial commodities. (We suppose that the agricultural sector consumes only those goods which are produced within the country). Provided the ratio of the two expenditures is equal to one, to start with, stock of money would be constant as long as this ratio itself is. With the same condition, however, if the ratios were to rise, stock of money in the agricultural sector would also rise. On the other hand, a fall in this ratio would lead to a fall in the stock of money. Provided the ratio of the two expenditures is more than one, even this constancy would result in rising stock of money while a rising ratio would make for an even accelarated increase in that stock. A decline in the greater-than-one ratio would mean that for some

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* Conceptually the time relevant to the calculation of this expenditure would be that for which an average agriculturist desires to hold his money balance.

time the stock of money may rise but eventually it will contract.

Now given the amount of goods which the industrial and the agricultural sectors are selling to each other, the ratio of expenditure would depend upon the ratio of industrial and agricultural prices. If the former is rising faster than the latter, the ratio would fall, since the rate of rise in agricultural sector expenditure would be faster than the rate of rise in the industrial sector expenditure. In this case, the stock of money in the agricultural sector would decline. On the other hand, if the agricultural prices are rising faster than industrial prices, the opposite of this would happen. For the net outflow of money into the agricultural sector would be positive.

Thus assuming no change in the quantum of goods which the two sectors are buying from each other, improvement in the terms of trade in the favour of agricultural sector would mean higher stock of money in that sector and a deterioration in the terms of trade would mean a lower of stock of money in that sector. In other words, the behaviour of the stock of money in the agricultural sector is, on certain assumptions related to the terms of trade between industry and agriculture.

Index Number of Prices Received and Paid by Farmers in India
1953 = 100

	1951	1952	1953	1954	1955	1956
India - Punjab						
Prices Received by farmers (R)	96	94	100	94	78	97
Prices paid by farmers (P)	107	102	100	98	86	96
Cultivation cost	117	105	100	92	79	91
Domestic Expenditure	101	101	100	102	91	99
Ratio (R) : (P)	90	92	100	96	90	101
India - West Bengal 1954 = 100						
Prices received by farmers (R)	...	...	100	103	118	135
Prices paid by farmers (P)	...	...	100	98	106	113
Cultivation cost	...	...	100	92	103	105
Domestic expenditure	...	...	100	97	108	118
Ratio (R) : (P)	...	...	100	105	111	119

Original Base : Punjab September 1938, August 1939; W. Bengal 1939.

Source: Eco. Survey of Asia and Far East, 1957-58, p. 203.

	1956	1957	1958	1959	1960	1961	1961		1962	
							III	IV	I	III
India - Punjab										
Prices received by farmers (R)	90	97	100	107	102	99	97	99	103	97
Prices paid by farmers (P)	88	96	100	108	106	108	112	107	113	113
Cultivation cost	87	91	100	111	108	107	106	102	107	106
Domestic Expenditure	90	99	100	107	105	110	114	113	116	117
Ratio (R) : (P)	102	101	100	99	97	91	96	93	91	86
India - West Bengal										
Prices received by farmers (R)	83	94	100	98	104	98	102	100	92	100
Prices paid by farmers (P)	89	95	100	101	104	106	109	107	104	108
Cultivation cost	93	95	100	105	107	110	114	115	111	113
Domestic expenditure	87	95	100	98	103	104	107	106	100	105
Ratio (R) : (P)	93	99	100	98	100	92	94	99	89	93

Original Base : Punjab September 1938 - August 1939; West Bengal, 1939.

Source : Economic Survey of Asia and Far East 1962, p. 222.

will the quantum of goods bought by the two sectors remain constant over time? One should think it would not since rising population must occasion a greater demand for food, clothes and other articles of essential consumption. For analytical convenience, however, we assume that population in both the sectors is rising at the same rate and that this is reflected in a commensurate rise in the quantities of both types of goods entering into the transactions. With that assumption, the quantity bought by the two sectors from each other is variable but the ratio of their respective expenditures would change only with the variation in the industrial and agricultural prices.

In brief, terms of trade would still be the principal determinant of the behaviour of the stock of money in the rural sector.

If there is expansion in bank credit or cash supply in the industrial sector, this would mean an expansion in money supply in the rural sector also provided this expansion raises agricultural prices more than the industrial prices. Now whether increased money demand of the industrial sector for agricultural commodities resulting from monetary expansion in that sector would raise the agricultural prices to that level would depend upon whether higher money demand does or does not synchronise with a commensurate rise in the marketable surplus of the agricultural sector. If the marketable surplus rises to the extent of the rising demand or more than that, agricultural prices may not rise and the expanded stock of money would remain within the industrial sector itself. In the opposite case, agricultural prices would rise and lead to an increase of money supply in the rural sector as well.

One possibility is that the increase in money demand for agricultural commodities is more than the increase in the marketable surplus but the industrial prices are feeling an even more powerful upward thrust. In this case, even with rising agricultural prices, money supply in the agricultural sector would not rise since industrial prices are rising faster.

[Thus it would not be true to say that every expansion of money supply in the industrial sector must necessarily mean an expansion of money supply in the rural sector.]

As mentioned earlier, just as it is difficult to isolate the factors which change stock of money in the rural sector, it is difficult to determine how the change is shared between the big and small cultivators. That the magnitude of the division of the increase is important is obvious enough. If the increase in stock accrues to the big cultivators who have different motives behind their asset preferences we will have one result; if it accrues to small cultivators, we will have another.

[In a broad and general way, increase in the stock of money in the rural sector would be shared in between the small and the big cultivators according to their share in the marketable surplus For the subsistence producers, it is possible that they sell less in order to obtain their target of cash and store more of what they produce, if the prices are rising. When the prices are low, they actually sell more at the expense of their self-consumption to satisfy their minimum cash needs. If that happens, flow of marketable surplus from the subsistence farmers can well be regulated by changes in the price of food. Roughly, at any rate, sharing of the increase in the money supply would follow the

sharing of the marketable surplus between the big and the small cultivators.

The following table gives some idea of the contribution of different types of farmers to the marketable surplus of India's agricultural sector.]

Sale proceeds as Percentage of Value of Gross Produce According to the Category of Cultivators in Selected Districts.

District/ category of culti- vators	Banga- lore	Hissar	Jaipur	Raiza- mabad	Mon- ghyr	Sagar	Deo- ria	Sor- ath	Jal- pai- guri
				Food-grains crops					
Big	22	48	29	41	31	31	2	1	41
Large	16	48	25	35	21	29	1	2	37
Medium	5	43	18	15	2	23	-	1	12
Small	1	51	15	5	-	18	-	2	17
All	11	47	21	26	14	26	1	1	26
				Commercial crops					
Big	86	73	88	97	63	57	88	96	99
Large	89	96	81	97	42	64	86	96	100
Medium	94	100	50	97	46	86	84	98	96
Small	100	100	50	100	-	75	87	97	97
All	90	100	75	98	42	75	85	97	100

The subsistence norm is not the same for all districts, it ranges between 2.3 acres for Jalpaiguri (1958-59) to 6.9 acres for Sorath (1957-58).

Source: Reserve Bank of India Bulletin, September, 1964, p. 1156.

It can be seen that in almost all the districts the proportion of sale to gross produce goes on declining as one moves from

big cultivators to the small ones. In predominently food growing districts like Nizamabad, Jalpaiguri, Monghyr, and Saugor where big cultivators sell as much as 30 to 48% of their food-grain crops, the small cultivators sell nothing at the minimum and 18% at the maximum. In fact, in Deoria and Jorath where cash crops are important, even the big cultivators sell only a negligible proportion of their food-grain crops.

It is thus clear that an overwhelming proportion of the increase in money supply in the rural sector goes to the big cultivators, the small cultivators getting either nothing out of that increase or a very small proportion. Thus even rising agricultural prices and more advantageous terms of trade do not make much of a difference to the deficiency in the transactions cum precautionary demand for money of the poorer section of the rural community. The pressure upon interest rates can be eased only if the increased stock of money with the big cultivators is reflected in increased supply of loanable funds. But that obviously would depend upon the asset preferences of the big cultivators who are, as we have seen earlier, motivated by a desire to speculate and to maximise the advantage from the assets they eventually decide to hold. If rising agricultural prices synchronised with the rising prices of industrial goods, the small cultivators transaction-cum-precautionary demand for money may increase just when the stock of money with the big cultivators is increasing.

In this case, the upward pressure upon interest rated would again be maintained. In fact, in such a situation, it is possible for the cultivators to step up their real demand for gold if inflation has worsened the feeling of insecurity. Further if the

small cultivators succeeded in getting loans no matter if that is at higher rates of interest, their money demand for gold may also be higher. Thus in a period of rising prices of such consumers' goods as are in demand by the poorer sections of the rural community, it is possible for gold prices to rise along with the rising interest rates and rising stock of money in the rural sector.[9]

The same may not be said about the relationship between cereal prices and the rates of interest because rising cereal prices are unlikely to reduce the small cultivators' share of cereals, they being in most cases producers of cereals themselves. It is only when rising cereal prices reduced the food available to the small cultivators that their transactions balances would be deficient. But this is rather unlikely. In fact, rising cereal prices may induce some small cultivators to withhold larger stocks from the market in the hope of making a capital gain. It is obvious that if for any reason rising cereal prices reduced the amount available for the consumption of the poor farmers, the demand for loans making up transactions - deficiency would be even more in elastic and therefore, rate of interest would rise to a level higher than before. Normally, however, rising cereal prices should not cause deficiency in the transactions balances of that magnitude which rising industrial consumers' goods prices may cause.

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9. cf. 'An Emperical Study of Indian Gold Prices'; Alan Heston, <u>Indian Economic Journal</u>, January, 1961.
Mr. Heston has calculated the elasticity of gold prices with respect to consumers price index, at the mean values of the variables to be 1.60.
'This elasticity implies' he says 'that a 1% rise in the consumers price index is associated with 1.60% increase in the price of gold'. Mr. Heston was studying this correlation for India for the period 1952-59.

It might be helpful to remember here that the rural people's demand for industrial consumers' goods is also not as elastic as might appear on the face of it. Extra clothes are a must not so much perhaps for daily wear as for a marriage, since for daily wear, it is possible to manage with worn out clothes for some more time. For a cultivator it may be as necessary to borrow for marriage gold and cloth as for food. But certainly in case of borrowing for food, the degree of exploitation by the lender would be much greater. And so the rate of interest on loans would also be much greater. In situations of famine, this could be possible and if rising cereal prices are indicating very poor harvests rather than speculative hoarding, rising cereal prices and rising rate of interest should go together as much as rising industrial consumers' goods prices and rising rate of interest. In such a situation, the cultivators might have even to give up insistence upon the precautionary motive all together because after all when they are on the verge of starvation, their first and only concern is to avoid starvation and satisfy the transactions motive. They would beg and borrow but since the rate of interest might shoot up very high, they may have to use gold and chattel to replenish their transactions balances. Provided that happened, gold supply might turn out to be greater than gold demand and gold prices should decline. There is, therefore, a possibility of rising cereal prices leading to a decline in gold prices.

It is well to remember that in such a situation, the big cultivators might also be tempted to unload gold though for a different reason. They may be interested in speculation in cereals because cereal prices are rising. In such speculation, they might

be wanting more funds than they had at their disposal and this demand for funds might partly result in a higher rate of interest and partly in a higher unloading of gold and in lower gold prices.[10]

Thus when cereal prices are rising because of very poor harvests both the small and the big cultivators' behaviour might be such as to lead to a rising interest rate and lower gold prices.

The essential considerations are two: (a) whether rising cereal prices have resulted in a net flow of money into the agricultural sector and (b) whether the rise in prices is due to speculative hoarding or lower production. There is no easy generalisation that could be possible in respect of these two considerations. When low production and speculation go together, the net flow of money supply into the agricultural sector may be positive, zero or even negative. It might be negative because the total marketable surplus of cereals might have declined faster than the cereal prices have risen.

Provided rising cereal prices have resulted in a net inflow of money supply to the agricultural sector and are not synchronising with decreased production, the small cultivators may not be obliged to liquidate their gold holdings. In fact, if part of the increased money supply accrues to them and prices of industrial goods are rising less rapidly than their stock of money supply, their demand for gold might even be higher than before. Whether in such circumstances gold prices would fall would depend upon the extent to which the big cultivators are obliged to unload gold for speculation in cereals. It is doubtful if the amount of gold thus unloaded would be more than the increase in the demand for it

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op. cit., pp. 219-220.

emanating from the side of the small cultivators because numerically big cultivators are few. Moreover they being more rational and less bothered about economic security they may not be having as big hoards of gold as we might imagine. Lastly, they can, for the reason of their bigness, command more finance from institutional sources at low rates of interest and use it for speculation.

It appears then that when rising cereal prices synchronise with falling gold prices the explanation might not be merely speculative unloading of gold as has been suggested,[11] it might be transactions unloading by the small cultivators. Speculative unloading itself might be rather insufficient to produce that result.

A factor which enters into the transactions and even the precautionary demand for money of the cultivators big or small, in a rather formidable way is livestock. Referring to the expenditure on livestock in some areas, a United Nations Study says, "In the Unchagaon block, the average expenditure on livestock for the three years ending 1958-59 amounted to 60% of the total value of agricultural assets acquired in the case of small and medium cultivators and 30% for large cultivators. In the corresponding non-block area, Siyana, 77% of the total value of the agricultural assets acquired by the small cultivators was accounted for by livestock, and the corresponding figures for medium and large cultivators were 69% and 64% respectively. The positon was similar in the Mahewa block, where livestock accounted for 79% of the total value of agricultural assets acquired by small cultivators and the

11. op. cit., pp. 219-220.

corresponding figures for medium and large cultivators were 76% and 72% respectively. Moreover, most of the households (85 to 100%) incur expenditure on livestock'.[12]

The report of the Agricultural Commission in 1937 and the National Income Surveys have revealed that approximately 40% of the agricultural income in India comes directly from livestock.[13]

Increase in the Number of Cattle and Baffaloes (1951-61)

Year	Cattle in millions	Baffaloes in millions	Total in millions	Increase over previous quinquennium (in millions)	Percentage increase over previous quinquennium
1951	155.2	43.4	198.6	-	-
1956	158.7	44.9	203.6	5.0	2.5
1961	175.7	51.1	226.8	23.2	11.4

Source: 'Census Figures Reveal New Trends in Cattle Population Growth': S.C. Chaudhry, Indian Livestock, January, 1963.

The above table shows that India's cattle population has been steadily rising. In fact, the rate of rise between 1956-61 is over four times as much as between 1951-56. In view of the fact that livestock supply about 2/5th of our agricultural income, increase in livestock cannot be treated as an unmixed course. But such increase coming on top of the fact that a good proportion of our

12. 'Capital Formation in Agriculture', Economic Bulletin for Asia and Far East, September, 1961.
13. 'Need to Avoid Lop-sided Plans for Livestock Development': P.S. Brar and D.P. Sharma, Indian Livestock, April-June, 1963.

livestock is uneconomic, cannot but have a disadvantageous impact upon the rural economy.

According to a study of the cattle problem, 'A primafacie consideration will suggest that if a phased elimination of dry cows to the extent of 20%, of all India basis ..... could be carried out, it is not likely to affect even remotely the present milk yield in unit rate or total production, but will immediately be reflected in higher indices of over all average rate, reduction in maintenance cost and corresponding reduction in the producing cost of milk..... As for the fear that such a reduction will affect the supply position of our working males it has been amply shown that there is no reason for it..... In our own interest, in the economic interest of the country and in the interest of making available more food to the starving millions of our unwieldy cattle population, it will pay if we are able to make such a modest reduction'.[14]

The disadvantageous impact of excessive growth of livestock is more or less the same as that of excessive growth of population. Money balances for feeding the cattle have to be maintained. If cattle population is rising, demand for money balances, other things remaining the same, would also rise and this rise in the transactions demand for money should mean a pressure on interest rates in the upward direction. No one minds an increase in the transactions demand for money as long as it is related to a rising real income. But uneconomic cattle hardly come in that category. On the other hand, if some thing can be done about excess cattle unnecessary transactions demand for money in the rural sector can

14. 'India's Cows and Plough Cattle'; I. Chatterjee, Indian Agriculturist, January-July, 1963, pp. 20, 21.

be cut out leading to a certain easing of pressure on interest rates in that sector.

Once again we might mention that the issue is more serious in respect of small cultivators than in respect of the big ones. As the U.N. Study referred to above indicated the proportion of expenditure on agricultural assets going to livestock is any thing between 60 to 79% in the case of the small cultivators.

In the situation, where the money supply in the rural sector contracts, say, for the reason of the terms of trade having gone against it, this deficiency would increase; and in the opposite situation it would increase.

Now assuming a certain level of borrowing by the small cultivators to make up normal deficiency in their transactions demand for money balances, increased money supply in the rural sector should reduce this borrowing and depress interest rates while reduced money supply should help increase this borrowing and increase interest rates. Not only may increased money supply reduce the deficiency in the small cultivators' transactions balances, it may also help increase supply of loans from indigenous non-institutional sources which, accounted for as much as about 93% of the credit supplied in the agricultural sector some year ago.[15] But whether such loans would necessarily increase would depend upon whether part of the increased money supply accrues to the non-institutional sources of credit and upon the asset preferences of the people involved in these sources.

Now, it may be suggested that money rates of interest in the rural areas are more determined by the own-rate of interest on

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15. All-India Rural Credit Survey Report, 1957, Vol. I, Part 2, p. 1. We are assuming money lenders, traders and commission agents to be non-institutional sources of credit.

loans taken and given in terms of commodities than by the supply and demand of cash or financial loans. But is there any real difference between the two suggestions? If people borrow grain, they do so because they have less than what they require for subsistence or security of afor payment as rent and wages. The more they are below subsistence level, the more they borrow and, therefore, higher the would be the own-rate of interest ruling on current loans. However, the more they are below subsistence level, the more should be the deficiency in the transactions cum precautionary balances too; the more would also be the demand for financial loans and the higher would be the rate of interest on financial loans. It is difficult to see how the two can move in opposite directions.

The main cause behind the high rates of interest in agricultural sector is the poverty of the people. As long as the agricultural out-put is what it is in relation to rural population, that poverty will continue to keep the interest rates high. Poverty leads to borrowing for essential consumption and even for economic security. From the side of the borrowers it naturally results in a willingness to offer rates of interest which bear no relation to the return from production. From the side of the lenders such borrowing is risky because there is no guarantee about when and how the borrowers would be able to return the loan. The following table will give an idea of the rates of interest that rural borrowers would be willing to pay to their leaders.

Borrowed Money as Percentage of total Capital or Outlay	Productivity of Capital (Total Outlay) in Per cent per Annum												
	100	90	80	70	60	50	40	30	20	10	5	3	1
100	100	90	80	70	60	50	40	30	20	10	5	3	1
90	111	100	89	78	67	56	44	33	22	11.1	5.6	3.3	1.1
80	125	113	100	88	75	63	50	38	25	12.5	6.3	3.8	1.3
70	143	129	114	100	86	71	57	43	29	14.3	7.1	4.3	1.4
60	167	150	133	117	100	83	67	50	33	16.7	8.3	5	1.7
50	200	180	160	140	120	100	80	60	40	20	10	6	2
40	250	225	200	175	150	125	100	75	50	25	12.5	7.5	2.5
30	333	300	267	233	200	167	133	100	67	33.3	16.7	10	3.3
20	500	450	400	350	300	250	200	150	100	50	25	15	5
10	1000	900	800	700	600	500	400	300	200	100	50	30	10
5	2000	1800	1600	1400	1200	1000	800	600	400	200	100	60	20
3	3333	3000	2667	2333	2000	1667	1333	1000	667	333	167	100	33
1	10000	9000	8000	7000	6000	5000	4000	3000	2000	1000	500	300	100

Source: 'Interest Rates Outside the Organised Money Markets of Under-developed countries', U Tun Wai, I.M.F. Staff Papers, November, 1957, p. 111.

It has been already pointed out above that the fact of the loan being taken for consumption purposes involves risk which may be considerable. The idea of the estimate of the rates of interest that lenders would have to charge to compensate for defaults can be had from the following table.

Estimates of Interest Rates that Lenders would Have to Charge to Compensate for Defaults.

(In per cent per annum)

Value of Defaults as Percentage of Total Loans	Normal Interest Rate in Absence of Defaults						
	1	2	5	10	15	25	50
1	2.02	3.03	6.06	11.11	16.16	26.26	51.52
2	3.06	4.08	7.14	12.24	17.35	27.55	53.06
5	6.32	7.37	10.53	15.79	21.05	31.58	57.89
10	12.22	13.33	16.67	22.22	27.78	38.89	66.67
15	18.82	20.00	23.52	29.41	35.29	47.06	76.47
25	34.67	36.00	40.00	46.67	53.33	66.67	100.00
50	102.00	104.00	100.00	120.00	130.00	150.00	200.00

Source: U Tun Wai, I.M.F. Staff Papers, p. 110.

The above figures indicate that with a normal rate of interest of 15% per annum, a rate of default of 5% would raise the supply price of loans to 21.05% per annum. The more the cultivators are below the poverty barrier, the greater would be the risk of default and, therefore, the greater the rate of interest which the lenders in the rural sector would like to charge. There

for repayment of production loans but in consumption the built in mechanism

is a built-in mechanism) can only be related to increased availability of consumers' goods which is only another name for

accelerated production in the rural sector. In fact, even loans taken for production are not entirely rational proposition. Loans taken for maintenance of uneconomic milk-giving cattle are a case in point. In the rural sector the dividing line between demand for loans decided upon after rational calculation and that determined by the emotional factors (marriage demand for gold, loans for maintenance of cattle) is very thin indeed.

Thus as long as agricultural production is not increasing, increased supply of finance would not reduce rural interest rates. Assume for the sake of argument that every one of the poorer sections of the rural community experiences a big rise in the volume of his money balance. Since the first charge on this balance would be provision of minimum of subsistence and security, every one would like to buy essential consumers goods and gold first. But if prices of these articles have risen in more or less the same proportion because their production is stationary, every one will be having a deficiency in his money balances again. And so the keenness to borrow for consumption and security would remain, helping to keep the rate of interest at a high level.

It seems, therefore, that for the rural sector it may make no difference whether we are analysing interest rates in terms of the supply and demand for grains or the supply and demand for money.

<u>The Case of the Big Cultivators</u>

What about the demand for money of the big cultivators? What is it eventually going to be related to?

There is no question of the big cultivators not having transactions or precautionary demand for money. But on top of that

demand, they may also have speculative demand for money which the small cultivators ordinarily do not have.

As the following table will show, over 70 per cent of the holdings operated in India belong to the big cultivators.*

Size group of holdings (acres)	Per cent	
	Number of holdings	Area operated
Less than 1	42.1	1.2
1 - 5	29.1	14.4
5 - 10	14.2	18.5
10 - 50	13.5	48.8
Over 50	1.1	17.1

Source : National Sample Survey, VIIIth Round, 1953-54, No. 66, 1962, p. 80.

As for the income of the various categories of cultivators, the total annual per capita income from land of those operating holdings of .01 to .99 acres is Rs 8 while that of those operating between 1.00 to 2.49 acres is Rs 54. In the third group, namely, that relating to 2.50 to 4.99 acres, the annual income rises considerably and is Rs 107. For groups operating holdings between 5 - 7.49 acres and 7.50 - 9.9 acres, the annual per capita income are Rs 164 and Rs 218 respectively. Per capita annual income is Rs 297 for the group holding 10 - 14.99 acres and Rs 397 for the group holding 15 - 19.99 acres. At and above 20 acres, the per capita annual income of the cultivators is above Rs 502; for those lying between 33.00 - 49.99, it is Rs 819. For cultivators operating

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* Assuming the big cultivator holdings to mean those above 10 acres.

above 50 acres (and the area they operate is, we might recall, as much as 17.1 per cent of the total) the per capita income is as high as Rs 1538 per annum.[16]

Annual and Monthly per capita Income of Rural Households from Agriculture in India.

Size of household operational holding (acres)	No. of households (000)	Size of household	Total persons (000)	Area (P.C)	Income from land* (Rs crores)	Income per capita from land (annual) Rs	Total monthly per capita income Rs
1	2	3	4	5	6	7	8
0.01 - 0.99	19486	4.14	80672	1.24	64.48	8	1
1.00 - 2.49	9253	4.81	44507	4.66	242.32	54	4
2.50 - 4.99	9856	5.24	51645	10.65	553.80	107	9
5.00 - 7.49	5605	5.76	32285	10.18	529.26	164	14
7.50 - 9.99	3469	6.16	21369	8.96	465.92	218	18
10.00 -14.99	3497	6.34	22171	12.68	659.36	297	25
15.00 -19.99	1887	6.76	12756	9.73	505.96	397	33
20.00 -24.99	1022	6.86	7011	6.77	352.04	502	42
25.00 -29.99	700	7.15	5005	6.70	296.40	592	49
30.00 -49.99	1209	7.23	8741	13.60	707.20	809	67
50.00 & above	645	8.30	5353	15.83	823.16	1538	128
Total	56629	5.01	291515	100.00	5200.00	183	15

* Total income has been distributed according to percentage of area under each size class.

Source : 'Rural Incomes in India' : P.C. Bansil, Paper submitted at the Third Indian Conference on Research in National Income, p. 6.

16. 'Rural Incomes in India'; P.C. Bansil, Paper submitted at the Third Indian Conference on Research in National Income, p. 6.

Not only are the big cultivators very much better off than the small ones, they pocket a very high proportion of rural income. As the above table suggests, out of a total rural income from land of Rs 5,200.00 crores, the households operating holdings of 10 acres or above accounted for Rs 3,344.12 crores of income which was easily more than half the income from land of the rural areas.

It is natural that the big cultivators do not confine themselves to satisfying the transactions and precautionary motives as the small cultivators do. They interest themselves in the speculative motive as well.

What, we might ask ourselves, are the assets which the big cultivators like to hold as wealth? Land, gold, commodity stocks and loans appear to be the obvious alternatives. In other words, extra money with these cultivators is likely to be directed either towards buying land or gold or towards building up commodity stocks or giving loans to the people.

Which alternative is more preferred will evidently depend upon the net advantage accruing from each of the various alternatives. From gold, the net advantage will be liquidity plus the capital gain or loss resulting from fluctuation in gold prices. In addition, there will be the prestige value which is attached to gold in the backward economies and the use of gold as a security asset.

From land, the advantage would be either the yield available if the asset holder chooses to cultivate it himself using his own labour or the rent if he chooses to lease it out to tenants or the profit if he chooses to cultivate it using hired labour. The disadvantage of land is its lack of liquidity. Land has also a

prestige value in agrarian economies and this will be a plus factor in the net advantage.

Whether the net advantage from land would be one or the other of these three possibilities would depend upon the premium which the land-holder places upon his own labour, the rent which he would get by leasing out his land to tenants and the level of wages of the hired labour.

In view of the fact that rents of land may be fixed in terms of money, the behaviour of prices would be a relevant factor. Rising prices may reduce the real value of rent and may, therefore, go against the desire of leasing out land. On the other hand, the tenants, in a situation of rising prices, may feel obliged to sell their produce to the landlord who intentionally helps them out of their difficulty by lending them at profitable rates of interest. If that happens, what the landlord looses in rent, he gains in cheaper purchase of the produce and a higher rate of interest. However, this would be so more in a situation where prices are arising owing to a poor harvest and less in that where they are rising due to speculation. In the latter situation particularly, when rising agricultural prices result in turning the terms of trade against the industrial sector and in a net inflow of money supply into the agricultural sector, the tenants' dependence upon the landlord for transactions cum precautionary funds may not increase. So that while the rent in real terms would decline, the cheap purchase advantage and the interest available to the landlord in real terms would decline too. In such a situation, much will depend upon the behaviour of real wages. If real wages are declining faster than rent in real terms, it will be advantageous to

hire labour and use land rather than lease it out. If the real wages are not declining faster or not declining at all and the landlords do not put a high premium on their own labour, landlords may get more advantage by cultivating their lands themselves.

In any case, it cannot be definitely stated that landlords would be inclined towards leasing out land to tenants rather than cultivating it themselves or with hired labour.

Now if the landlords take to self-cultivation or to cultivation with hired labour, the yield from the newly acquired land will have to be deflated by the extra prices which they would have paid because of the increased demand for land raising land prices. However, this may not make much difference if the rise in the price of the product fully compensates for the rise in land prices. Such compensation, it is obvious, is not just a matter of the current prices of the products; it would depend upon the expected prices of those products as well.

But once we introduce the factor of expectation, land may not be as fascinating an alternative since owing to pressure of demand, land prices would shoot up more rapidly than commodity prices. There is an interesting reason for it. Since the big cultivators are in many cases traders also, their commodity stocks could increase without their demanding it in money terms. All that they would need to do is to reduce the surplus which they have been releasing thus far to the market. In the case of land, more land cannot be acquired by any such internal arrangement; it will be bought in terms of money and this will raise money demand for land and also land prices. On balance then, land prices when land is preferred should rise faster than commodity prices when commo-

dities are preferred. However, rising land prices would cut into the advantage available from land as a marginal asset and make commodities more profitable.

But the more important reason for this preference would be the expectation that because the current return on land is declining, land prices would not rise as much in the future as is hoped for. On the other hand, commodity prices could even be made to rise, since holders of commodity stocks can operate the lever themselves. They have no means of directly influencing land prices.

It seems, therefore, that when fixed money rent is assumed, the net advantage in holding extra land is unlikely to be high. However, if rent and interest are paid in kind, the net advantage in holding land may be higher. For then with rising prices which might be synchronising with greater money supply in the rural sector, real rent may not decline fast enough to neutralise the advantage of a high own-rate of interest on account of loans given to the tenants who are leasing in land or the advantage of lower real wages if the landlord is cultivating the land with hired labour.

What about the return from loaning out money to the needy labourers? As pointed out earlier, if the small cultivators and the landless labourers are taken farther away from the poverty barrier and, therefore, their demand for transactions cum precautionary balances is increasing, rate of interest would rise. The important question then would be whether the rising interest income from loans would be greater than the capital gain from the disposal of hoarded commodity stocks. Once again expectation would be important since if the expectation is that commodity prices would not

very much rise, the capital gain from commodity stocks would be lower than the interest gain and loaning funds to the needy cultivators or landless labourers might be preferred.

Fundamentally, the expectation in regard to future prices of agricultural commodities is related to the hopes and fears concerning elasticity of agricultural out-put in the short period and the rate of investment in the industrial sector. If it is definite that the investment in the industrial sector would keep on rising while the supply of agricultural out-put would not be very elastic, the expectation of higher commodity prices would be stronger and so the expected capital gain would also be commensurately higher. There will then be greater preference for holding commodity stocks than before.

But three other factors are also to be noted.

One is anticipation in regard to the next one or two crops which may be difficult to make because crops depend upon the weather. This sets a limit to the time-horizon for speculation. Normally this time is the period lying between one crop and another, but with the assurance that the Government, because of its determination not to allow any obstacles in the way of rapid economic development, can be forced to support agricultural prices, this time can be longer.

We might recall that we had referred to the expected price of land as a factor entering into the calculations of agriculturists with surplus money. We had said that there was reason to suppose that this expected price would not be reckoned to be as high as the expected price of commodities. The point becomes clearer here. If the time-horizon of the speculators is very brief,

(say that between one crop and another), future land prices are not expected to get a real chance to rise. After all land prices do not rise over night as commodity prices do.

Another factor which is to be noted is that speculation is a luxury in which those who have staying power alone can indulge. The greater the staying power of the agriculturist the more he will be holding back stocks for speculation.

The third factor refers to easy availability of funds to the speculators. Other things remaining the same, the larger the funds that are made available for marketing and storing agricultural produce, the more would the agriculturists be enabled to get interested in speculation.

If economic development in the agricultural sector is such as to increase the staying capacity of and the supply of finance to big cultivators, without at the same time rectifying the lack of balance between the rate of growth of income in the industrial sector and increased output in the agricultural sector, speculation would become a highly fascinating activity, and increased money supply would not result in a commensurate increase in loanable funds to the bulk of the rural population. As long as that happens, interest rates in the rural sector would remain high despite increased money supply or increased credit facilities.

CHAPTER 17

MAIN FEATURES OF RURAL CREDIT IN INDIA

To get an idea of the main features of rural credit in India, we cannot do better than go to the findings of the Survey which was conducted at the instance of the Reserve Bank of India under the Chairmanship of Shri Gorewala.[1]

It will be seen from the following data available from the Survey that of the total amount borrowed by the cultivators, 3.3 per cent was from Government, 3.1 per cent from co-operatives and 0.9 per cent from commercial banks. Landlords and traders were also not important credit agencies, borrowing from them forming only 1.5 per cent and 5.5 per cent respectively of the total borrowings of cultivators. Relatives supplied 14.2 per cent of the credit obtained by the cultivators. By far, the most important credit agencies were the agriculturists and the professional money lenders who advanced 24.9 per cent and 44.8 per cent respectively of the total amount borrowed by the cultivators.

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1. All-India Rural Credit Survey, 1951.

Suppliers of Credit in the Agricultural Sector

(Amount in rupees per family)

Credit agency	Borrowings				All families	
	Cultivators		Non-cultivators			
	Amount	Percentage	Amount	Percentage	Amount	Percentage
	1	2	3	4	5	6
Government	6.9	3.4	1.0	1.5	4.9	3.1
Co-operatives	6.5	3.1	1.0	1.5	4.6	2.9
Relations	29.8	14.2	10.3	15.5	23.0	14.4
Landlords*	3.2	1.5	3.2	4.9	3.2	2.0
Agricultural money lenders.	52.1	24.9	16.4	24.8	39.7	24.8
Professional money lenders	94.6	44.8	25.1	38.0	70.1	43.8
Traders and commissions agents	11.5	5.5	6.5	9.9	9.8	6.1
Commercial banks	2.0	0.9	1.3	2.0	1.8	1.1
Other agencies	3.5	1.8	1.3	1.9	2.8	1.8
Total	209.5	100	66.1	100	159.9	100

* To tenants only.

Source: All India Rural Credit Survey Report, 1957, Vol. I, Part 2, p. 1.

The case of non-cultivators is only slightly different. They get a little more from traders and commercial agents than from landlords and commercial banks and a little less from Government, cooperatives and professional money lenders. But what they get from agriculturists and professional money lenders is more than 3/5th of their total borrowing from all sources. Credit from

Government, cooperatives and commercial banks ranges between 5 to 7.3 per cent of the total credit available to the cultivators as well as to the non-cultivators. The non-institutional sources have, therefore, a much greater importance than the institutional sources.

The All-India Rural Credit Survey gave the following picture of the purpose for which loans were taken and the uses to which those loans were supposed to be put.

Average debt owned by cultivators classified according to purpose and credit agency.

(Amount in rupees per family)

Purpose	Total		Credit Agency		
	Amount	Percentage	Government	Cooperative and commercial banks	Others
Agricultural: short term	28.9	9.1	1.5 (5.1)	2.1 (7.4)	25.3 (87.5)
Long term	79.8	25.3	7.5 (9.4)	2.0 (2.5)	70.3 (88.1)
Non-agricultural: short term	2.7	0.9	-	- (0.1)	2.7 (99.8)
Long term	6.3	2.0	- (0.7)	- (0.5)	6.3 (99.0)
Consumption: short term	67.8	21.5	1.3 (1.9)	1.2 (1.7)	65.3 (96.4)
Long term	68.6	21.7	0.7 (1.0)	0.5 (0.7)	67.4 (98.3)
Repayment of old debts	12.6	4.0	0.1 (1.0)	1.6 (12.8)	10.9 (86.2)
Others	49.1	15.5	0.5 (1.1)	0.7 (1.5)	47.9 (97.6)
Total	315.8	100	11.7 (3.7)	8.0 (2.5)	296.1 (93.8)

(Figures in brackets denote percentages to total debt).

The table shows that borrowing for agricultural purposes was 34.4% of the total borrowing of a typical cultivator family. Of

this amount, about 3/4th was borrowing for the long term and 1/4th borrowing for the short term. In respect of both the long and short term loans, the share of non-institutional sources was highest, such source supplying as much as about 88% of those loans. The share of the co-operatives and commercial banks in short term loans was 7.4% while that of the Government, 5.1%. In long term loans, the share of the Government was larger, i.e., 9.4% as against 2.3% supplied by the cooperatives and commercial banks.

Borrowing for non-agricultural purposes was hardly 3% of a cultivator family's total borrowing but almost the entire of this loan came from non-institutional sources.

As much as 43.2% of a cultivating family's borrowing was for consumption purposes and about half the amount borrowed was for a long period. Here too, the non-institutional sources claim the lion's share. In fact, almost the whole of consumption debt came from non-institutional sources. The table above shows that whereas the Government's shares in short term and long term consumption debts were 1.9 and 1 per cent respectively and the co-operative and commercial bank's, 1.7 and 0.7 per cent respectively, the non-institutional sources' shares were 96.4 and 99.3 per cent respectively. No wonder, therefore, that the interest rates in the unorganised sector of the Indian money market are so high.

Another useful information regarding rural credit which the All-India Rural Credit Survey made available was that whereas 4.5% of the borrowings of the big cultivators and 3.8% of the borrowings of the large cultivators were from Government, only 3.2% of the borrowings of the medium cultivators was from this

source. The avarage borrowing of the big and the large cultivators was Rs 34.0 and Rs 13.5 respectively per family and it was only Rs 5.6 per family in case of the medium cultivators.

(Amount in rupees per family)

Credit Agency	Big cultivators		Large cultivators		Medium cultivators		Small cultivators	
	Amount	Percentage	Amount	Percentage	Amount	Percentage	Amount	Percentage
	1	2	3	4	5	6	7	8
Government	24.0	4.5	13.5	3.8	5.6	5.2	2.3	2.0
Cooperatives	21.0	4.0	13.5	3.8	4.7	2.7	1.9	1.7
Relatives	73.9	14.0	51.8	14.5	24.3	14.1	15.0	13.5
Landlords (to tenants only)	3.7	0.7	4.0	1.1	3.1	1.8	2.5	2.2
Agriculturist money lenders	126.5	23.9	86.3	24.2	44.8	25.9	27.6	24.8
Professional money lenders	221.8	41.9	154.4	43.3	77.8	45.0	55.1	49.6
Traders and Commission Agents	40.3	7.6	22.4	6.3	8.5	4.9	4.6	4.1
Commercial banks	10.1	1.9	5.1	1.4	0.8	0.5	0.4	0.4
Others	7.7	1.5	5.6	1.6	3.3	1.9	1.9	1.7
Total	529.0	100.0	356.6	100.0	172.9	100.0	111.3	100.0

Source: All-India Rural Credit Survey Report, 1957.

The position in respect of co-operatives is no better. From the co-operatives big and large cultivators get 4 and 3.8 per cent respectively whereas medium and small cultivators get 2.7 and 1.7 per cent respectively. The big and large cultivators are at an advantage as regards borrowing from traders and commission agents as well as commercial banks. From commercial banks, the big cultivators borrow upto 1.9% of their total borrowing but the medium and small cultivators, upto 0.5% only.

The principal features of rural credit, then, are:

(1) that non-institutional credit in the agricultural sector is far out of proportion to institutional credit,

(2) that only a little over 1/3rd of the borrowing of cultivators is for agricultural purposes,

(3) that about 97% of credit for consumption comes from sources other than the Government, cooperatives and commercial banks,

(4) that the big cultivators are able to borrow more from Government, cooperatives, traders, commission agents and commercial banks than the small cultivators,

(5) that a couple of years ago, the percentage of households reporting outstanding debt was well over 50,[2]

(6) that, at the same time, the rate of repayment of loans was about ½ the amount currently borrowed.[3]

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2. 'All-India Rural Debt and Investment Survey, 1961-62': R.B.I. Bulletin, December, 1963.
3. Ibid.

CHAPTER 18

CREDIT FROM PRIMARY SOCIETIES

Since the All-India Rural Credit Survey Report was submitted, great emphasis has been given to augmenting the supply of credit in the agricultural sector. We might, therefore, analyse the progress of rural credit during this period and see to what extent the progress marks an improvement upon the situation as it was at the start of economic planning in India.

We would confine ourselves to the expansion of institutional, particularly co-operative credit because information in respect of other sources of credit is not available and also because this credit can be made to play a more direct role in financing the growth of the agricultural sector than, non-institutional credit.

First of all, we might take up the short term and medium term credit supplied by the primary agricultural co-operative societies.

Between 1950-51 and 1961-62, the total number of primary agricultural credit and multi-purpose societies has risen by 105%. While the number of unlimited societies rose by about 3,000 only - it was 75,309 in 1951-52 and 78,396 in 1961-62, the number of limited societies increased more than four times; from 29,189 in 1950-51 it became 136,547 in 1961-62. The membership of primary agricultural credit and multi-purpose societies rose almost 4½ times; while it was 41.08 lakhs in 1950-51, it became 195.60 lakhs in 1961-62. The performance in respect of share capital is even better. It multiplied about nine times. From Rs 7.61 lakhs which it was in 1950-51, it became Rs 68.61 lakhs in 1961-62. The statutory and other resources of these societies also increased though the degree of rise was not as much as in the share capital. The reserves rose from Rs 8.06 crores in 1950-51 to Rs 20.01 crores in 1961-62. The deposits of primary agricultural credit societies also increased four fold, for while they were only Rs 4.28 crores in 1950-51, they rose to Rs 17.6 crores in 1961-62. The rise in the working capital of these co-operatives was only a little less than the rise in the share capital. The working capital in 1961-62 was about nine times that in 1950-51 rising from Rs 37.25 crores in 1950-51 to Rs 325.25 crores in 1961-62.

Operational Details of Primary Agricultural Credit and Multi-purpose Societies

Year	Credit Operations (Rs in crores)				Average per number			Overdues as per cent of outstanding loans %	Cost of arrangement per society (Rs)
	Loans advanced	Loans recovered	Loans outstanding	Of which overdues	Share capital (Rs)	Deposits (Rs)	Loans advanced (Rs)		
1950-51	22.90	18.34	29.13	6.38	17.3	9.7	44	22	89
1955-56	49.62	38.25	59.84	14.96	21.6	9.0	64	25	80
1956-57	67.33	51.05	76.82	16.62	21.8	8.8	78	22	101
1957-58	96.08	64.91	107.10	22.79	27.6	8.4	94	21	127
1958-59	125.50	96.19	135.00	26.90	31.2	8.3	105	20	151
1959-60	168.40	125.33	177.88	37.93	32.5	8.2	116	21	205
1960-61	202.75	162.64	218.00	44.30	33.9	8.6	119	20	275
1961-62	228.09	190.46	256.69	62.92	35.1	9.0	117	25	323

Source: 'Cooperative Movement in India, Important Statistics, 1961-62', Government of India (Department of Co-operation), May, 1963.

The growth of loans advanced by the primary agricultural societies over the eleven year period ending 1961-62 has been phenomenal. The total volume of loans advanced by them increased more than 10 times to Rs 228.09 crores in 1961-62 from Rs 22.90 crores in 1950-51. However, the rise in loans advanced per member was not commensurate with the rise in the total volume of loans. Loan per member was Rs 44 in 1950-51 and Rs 117 in 1961-62 registering a less than fourfold increase as against more than double that increase in the total amount of loans made available to all members. The case in regard to deposits is even worse. We saw earlier that the total deposits of primary credit societies rose about four times but in the deposit per member, the table in question, shows a slight decline. Whereas this deposit was Rs 9.7 in 1950-51, in 1961-62 it was Rs 9 only. However, against the performance of the preceding five years, the deposit in 1961-62 shows an increase which might now continue.

There are two more facts to which this table invites our attention. The overdues have not gone below 20% of the outstanding loans during this period. There was a slight reduction in the percentage of overdues in the years 1957-58 to 1960-61, but it rose again in 1961-62. In that year, the overdues were about 25% of the outstanding loans belonging to the primary credit societies. Another fact which is indicated is that the cost of management per primary credit society increased from Rs 89 in 1950-51 to Rs 323 in 1961-62. Part of this rise was inevitable since we are now trying to improve the administration of these societies. But we should avoid too much expense on administration otherwise funds which could go into loans to cultivators would be wasted in merely maintaining our credit societies.

In 1957-58, short term loans given by the primary credit societies for seasonal agricultural operations, constituted 76.30% of the total loans made available by them. Since then this percentage has been slightly rising. It became 82.01 in 1958-59, 83.23 in 1959-60 and 85.39 in 1961-62. The loans for the purchase of agricultural implements have constituted a slightly fluctuating percentage in the sense that if they were 4.1% in 1957-58 and 4.19% in 1960-61, they were 3.11% and 3.27% in 1958-59 and 1959-60 respectively. In 1961-62, loans for agricultural implements constituted only 2.92% of the total short term credit of the primary agricultural credit and multipurpose societies. Loans for marketing of crops have constituted a slightly declining percentage. In 1957-58 and 1958-59, such loans were 3.49% and 3.57% of the total, in 1959-60, they were 2.88% in 1960-61, 2.76% and in 1961-62, 2.57%. Short term loans for industrial purposes have ranged between 0.59% in 1957-58 to 0.29% in 1961-62. There has been a slight decline in the proportion of the primary agricultural co-operative societies' credit going for industrial purposes. But the decline in consumption loans is considerable. From Rs 5.02 crores in 1959-60, the amount of such loans came down to Rs 3.90 crores in 1961-62. As a proportion of total short term credit, these loans have registered a more marked decline. While they were 4.33% in 1957-58, 3.67% in 1958-59, 3.26% in 1959-60, 2.45% in 1960-61, they were only 1.90% in 1961-62.

The medium term credit of primary agricultural credit and multipurpose societies was about 1/6th of the short term credit and 1/7th of the total in 1957-58. In 1958-59, medium term credit was about 1/8th of the short term credit and 1/9th of the total. For 1959-60, and proportions were 1/10th and 1/11th; for 1961-62, 1/9th

and 1/10th. Thus during 1960-62, the medium term loans advanced by primary agricultural credit and multipurpose societies was about 11% of the short term credit and 10% of the total. Medium term credit advanced for minor improvements in land was 18.13% in 1957-58, 19.61% in 1958-59, 21.93% in 1959-60, 19.57% in 1960-61 and 19.87% in 1961-62, that is, it continues to be a little less than 1/5th of the total medium credit available. The most important purpose behind medium term borrowing has been purchase of cattle. As much as 49.85% of the total medium term credit in 1957-58 was for purchase of cattle. This percentage, however, declined later. In 1958-59, loans for cattle constituted 47.82%; in 1959-60, 43.65% in 1960-61, 36.08% and in 1961-62, 37.29%. Thus there has been a marked decline in the proportion of medium term loans made available for the purchase of cattle. The items which have fluctuated both ways are loans for sinking and repair of wells and for the purchase of machinery. Loans for sinking or repair of wells were 4.09% of the total in 1957-58, 5.89% in 1958-59, 4.45% in 1959-60, 9.23% in 1960-61 and 6.11% in 1961-62. The proportion of loans for the purchase of machinery was on the whole increasing except in 1961-62 when it declined. In 1957-58, 4.53% of the total medium term credit was for the purchase of machinery. In 1958-59, the percentage rose to 7.42. In 1959-60, it was 7.38 from where it went up to 11.99 in 1960-61. However, in 1961-62, it declined to 8.04% even though the total amount of money loaned out for machinery was over Rs one crore higher than what it was in 1957-58.

In May, 1959, the Government of India formulated a scheme for providing supplementary finance amounting to Rs 8 crores to co-operative banking structure for financing loans in selected villages,

in 200 community development blocks, to those cultivators who could not obtain any credit from the co-operatives or who could get an inadequate volume vis-a-vis their needs for executing a given production programme. However, at a subsequent conference of the State Ministers of Co-operation held at Mysore in July, 1959, the consensus was that if the co-operatives advanced loans on the basis of production programmes and repaying capacity, the need for supplementary credit from Government would not arise. And so the Conference came to the conclusion that there should be only one line of credit.

From a certain point of view, the expansion in cooperative credit has been satisfactory. In 1951-52 when the All-India Rural Credit Survey found co-operatives supplying 3.1% of the total rural credit, the volume of loans advanced stood at a little over Rs 24.58 crores.[1]

However, in 1961-62, short term loans alone amounted to Rs 205.18 crores and medium term loans to Rs 22.90 crores. The Second Plan had placed a target of short term loans of the order of Rs 150 crores. In 1959-60, the target had already been exceeded by about Rs 4 crores. In 1961-62, the target was exceeded by as much as Rs 55.18 crores. In fact, the combined target of short and medium term loans for the second Plan was exceeded by the short term loans alone.

The Third Plan envisages that the membership of primary credit societies will increase to about 37 millions covering about 60% of the agricultural population. The number of societies is expected to increase by about 230,000 so as to serve all the villages in

1. Review of the Cooperative Movement, Reserve Bank of India, 1950-52.

the country. It is estimated that the total amount of short and medium term credit may increase to about Rs 530 crores and that of long term credit (loans outstanding) to about Rs 150 crores.[2]

Between 1951 and 1961, the short term and medium credit went up by Rs 200 crores. Judged by this standard, the Third Plan target of Rs 530 crores (that is an increase of Rs 330 crores) would appear a little ambitious though not impossible to achieve. The rate of expansion in cooperative credit has been particularly rapid over the past five years. If the Third Plan targets are achieved the total cooperative credit by the end of the Plan would stand at Rs 680 crores which would be very near the total of all rural credit in 1951-52.

The following table gives us an idea of the progress of primary agricultural societies at the end of each Plan.

Progress of Agricultural Credit Societies

Item	Beginning of First Plan (1950-51)	Beginning of Second Plan (1955-56)	Beginning of Third Plan (1960-61)	1961-62	1962-63 (Provisional)	Third Plan Target (1965-66)
I. **Primary Agricultural Credit Societies**						

Source: 'Community Development and Cooperation – [illegible] Administrative Intelligence Unit, Ministry of Community Development and Cooperation, February, 1964, p. 53.

The credit provided by the co-operatives to the agriculturists as a proportion of the total needs of the farmers has increased from about 3% in 1951-52 to about 15% in 1961-62.

However, the impact of such expansion on small cultivators has rather been negligible. According to the data available from the National Sample Survey, as many as 85% of the cultivators in India operating about 1/3rd of the total farm land in the country are small cultivators having cultivated holdings below 10 acres. This group mainly consists of small owners, farmers, tenants, artisans and agricultural labourers.

Rural Credit Follow-up Surveys conducted by the Reserve Bank of India give the following picture of the borrowings of small cultivators from the co-operatives.

The small cultivators suffer from certain disabilities on account of which they do not derive that benefit from co-operative# credit which big cultivators do.

One inability is related to their enrolment as members of cooperative societies. There are several reasons for it. First of all, many of them are landless tenants and the co-operative societies advance loans only on the mortgage of land. Secondly, they might be belonging to backward classes to whom the upper class people do not wish to give any encouragement. Thirdly, the illiterate class of people might not be getting suitable information and guidance in respect of the benefit which can be got from the cooperatives and lastly, private traders and money lenders might threaten to stop giving loans to them if they chose to go over to co-operatives. For, in any case, all credit needs of the cultivators would not be met by co-operatives. In addition small cultivators may not be having money to buy shares and debentures of co-operative societies. The usual practice is to deduct 1/10th of the loan granted as share of the society supplying credit but while this fulfils a certain legal requirement, it reduces the net amount of loan available to the poor cultivators.

As the Committee on Co-operative Credit observed, "there may however, be members owning or cultivating small bits of land but may not be able to pay entire value of the share at the time of taking the first loan. In such cases, insistence on the payment of share capital in full may not only cause hardship but may actually stand in the way of their becoming members".[3]

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3. Report, p. 88.

The Committee, therefore, recommended that the share in such cases, be paid in instalments. For example, for a person requiring loan upto Rs 200, the first immediate instalment of each share (he should buy two) may be Rs 5/- and the balance of Rs 5 may be paid over the next two years in instalments of Rs 2.50 each.[4]

One more reason why small cultivators are discouraged from borrowing from co-operatives is their inability to utilise their loans properly. If cash loans for productive purposes are given and they have pressing consumption needs, there is every likelihood of the loans being directed to consumption rather than production.

Grant of credit should, therefore, go hand in hand with technical assistance and welfare work. Only then can we hope to increase productivity and living conditions in the rural areas.

The main thing in supervised credit is the cost of supervision of which we do not have very accurate and reliable data. In this connection, the report of the Rural Development and Credit Project in Delhi published by the Indian Cooperative Union evaluating the results achieved during the period Rabi 1957-58 to Kharif 1959 (September, 1959) under this programme in the Mehrauli block, about 9 miles South-West of New Delhi, could be useful.[5]

This project was designed to serve small farmers (operating less than 15 acres) and tenant cultivators. The credit requirements were assessed on the basis of suitable and realistic plans of farm production.

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4. Ibid.
5. 'Supervised Rural Credit', Manilal B. Nanavati, Indian Journal of Agricultural Economics, October - December, 1961.

A sample of cultivators who participated in this project showed that the average annual gross farm income of all the selected areas increased by Rs 247 or 16.6% from Rs 1484 in 1956-57 to Rs 1,731 in 1957-58. The average gross farm income per acre increased by Rs 22.1 from Rs 132.5 to Rs 154.6 during the same period. It is noteworthy that the increase in gross farm income per farm was greater amongst those cultivators who operated 3 to 12 acres. Cultivators operating more than 15 acres had an increase of less than Rs 15 per acre only while those operating less than 3 acres had an increase of Rs 70.7 per acre.[6] This shows that the scope for increasing production and incomes on a large majority of uneconomic farms by suitable farm planning and technical guidance is considerable. The average net farm income per family increased by nearly 92% from Rs 122 in Rabi 1956-57 to Rs 234 in Rabi 1958-59. There was, however, a decline in the average net farm income during the Kharif season 1957-58 by Rs 68 from Rs 315 to Rs 247. The cultivators receiving short and medium term loans together had, at an average, greater increase in farm income than those taking short-term loans only.

On the cost side, the study revealed that the cost of operation per acre of operated land in relation to supervised credit services increased by 46.6% from Rs 8.58 in 1956-57 to Rs 12.58 in 1958-59 (for 9 months only), and the cost per loanee served increased by about 68% from Rs 78 to Rs 131.3 during the same period. Relating changes in farm and off-farm income to the per acre cost of operation (1955-56 base year), it was noted that during 1956-59 (33 months), for every Rs 16/- spent on recurring cost, there was an average increase of Rs 100 in total annual gross income (farm income plus off-farm

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6. Ibid.

income) of the loanees. Costs as related to annual gross income also tended to decrease each year.

Finance to be effective must be made part of a well planned and integrated scheme of rural development with provision for adequate supervision at various stages. It is true that the cost of supervision in the earlier stages might be higher than we think but such cost should be treated as necessary investment. Later as productivity increases, the cost per acre or per unit of output financed by co-operative loans should automatically decline.

CHAPTER 19

LAND MORTGAGE BANKS

Long term finance in the rural sector is provided by two agencies particularly - the State Government and the Land Mortgage Banks. The State Government in U.P. provides *taccavi* loans but a considerable proportion of such loans is distress taccavi rather finance for development. Thus the only important agency for long term finance is Land Mortgage Banks.

The earliest efforts made in the direction of setting up special Land Mortgage Banks were made in the Punjab, the first Cooperative Land Mortgage Bank having been organised at Jhange in 1920. Madras followed suit by organising two banks of that type in 1925 and Bombay by forming three banks in 1929. The movement gradually spread in these as well in other States.

The principal suggestions of the Registrars' Conference of 1926, of the Royal Commission on Agriculture and the Central Banking Enquiry Committee were:-

1. Land Mortgage Banks should be organised under the Cooperative Societies Act. Their area of operation should not be so large as to become unwieldy nor so small as to be uneconomic.

2. The principal objects for which loans may be advanced should be:

(a) redemption of land and houses of agriculturists;

(b) improving of land and methods of cultivation;

(c) liquidation of prior debts;

(d) purchase of land in special cases.

3. Loans should not exceed half the value of properties. Each bank should provide in its bye-laws a minimum and a maximum up to which it may advance individual loans. The minimum should be such as to repay cost of the transaction to the bank and such as primary societies cannot conveniently give.

4. Land Mortgage Banks should provide a suitable agency for distribution of loans under the Land Improvement Loans Act.

5. No loan should be advanced which is not economically profitable to the borrower.

6. The amount and the period of loan should be fixed with due regard to the repaying capacity of the borrower and also to the purpose for which loan is advanced.

7. Under the existing circumstances, the period of loans should not exceed 20 years.

8. The primary credit society concerned should be consulted in the case of a loan application received from a member of the society.

9. The debentures should be issued by a central financing body which may be called a Provincial Land Mortgage Corporation. Interest on debentures should be guaranteed by the Government and they should be added to the list of trustee securities.

10. Government should grant subsidy to Land Mortgage Banks in the initial stages of their working. Concessions given to these banks in the form of stamp duty, registration fees etc., should be continued.

11. Land Mortgage Banks should be given power of foreclosure and sale without recourse to civil courts subject to certain safe-guards.

12. Provincial Cooperative Banks should not function except as a temporary measure as Central Land Mortgage Banks for the province (now State). There should, however, be no objection, until a Provincial Land Mortgage Bank is established in a province, to the provincial Cooperative Bank financing primary land mortgage banks with long term capital especially raised for the purpose.

The real beginning in the field of land mortgage banking in India was made with the organisation of a Central Land Mortgage Bank in Madras in 1929.

The period of the war witnessed a general shrinkage in the business of Land Mortgage Banks. But later, on account of the obvious fact that agriculturists had to be helped to produce more, this arrangement for long term assistance was naturally expanded.

According to the Report of the Committee of Direction of the All-India Rural Credit Survey, the total number of Central Land Mortgage Banks in India, on 30th June, 1951, was five. On the same date, the total number of primary land mortgage bank was 286 of which 208 were in Madras and Mysore alone. Madras led because the number in Madras was 129 while that in Mysore was 79.

On 30th June, 1951, the working capital of the central land mortgage banks in India (excluding that of the Department of the Madhya Pradesh Provincial (State) Cooperative Bank) defined so as to include paid-up share capital, reserve fund, other funds, loans from Government, loans and deposits from banks and societies,

individuals and other sources and debentures stood at Rs 772.1 lakhs. Of this, nearly 75% was accounted for by the Madras Co-operative Central Land Mortgage Bank. Debentures accounted for more than 80% of the working capital in Madras, Bombay and Mysore. In Orissa, about 44% of the working capital was accounted for by loans from Government. Owned funds constituted less than 13% of the working capital of the Central Land Mortgage banks in all states.

The total working capital of all the primary land mortgage banks in India amounted to Rs 6,65.7 lakhs as on 30th June, 1951, of which the primary land mortgage banks in Madras accounted for Rs 473.7 lakhs. In Madras and Mysore, borrowings held at the end of the year from central land mortgage banks accounted for 90% of the total working capital of primary land mortgage banks. In Bombay, they accounted for only 60% of such capital. In Madhya Pradesh, borrowings from appex banks accounted for 82% of the total working capital whereas in West Bengal borrowings from the Government formed about 68% of the total working capital of the primary land mortgage banks. In Uttar Pradesh, loans and deposits from bank, societies, individuals and other sources constituted about 60% of the total working capital. Primary land mortgage banks were rather undeveloped in Rajasthan, Madhya Bharat and Assam.

A look at the following Tables will indicate the progress which land mortgage banks have made in India since the beginning of the First Plan.

First we might have a look at the progress of the primary land mortgage banks.

(Rupees in crores)

Year	Number	Membership (in lakhs)	Share capital	Outstanding borrowings	Working capital	Loans: Advanced	Loans: Recovered	Loans: Outstanding	Loans: Overdues	Overdues as per cent of outstanding loans
1	2	3	4	5	6	7	8	9	10	11
1950-51	286	2.15	0.52	5.97	6.66	1.29	0.46	6.26	0.08	1.3
1955-56	302	3.14	0.86	10.19	11.35	1.74	0.80	10.51	0.24	2.3
1956-57	326	3.34	0.99	11.39	12.70	2.05	0.85	11.51	0.30	2.6
1957-58	347	3.76	1.07	12.42	14.06	2.52	1.11	13.08	0.34	2.6
1958-59	363	4.40	1.25	14.58	16.50	3.27	1.21	15.14	0.40	2.6
1959-60	406	5.50	1.55	18.09	20.39	5.10	1.43	19.22	0.50	2.6
1960-61	463	6.69	1.97	24.13	26.99	7.17	1.73	24.66	0.64	2.6
1961-62	535	8.52	2.82	34.25	38.42	12.58	2.19	35.27	0.89	2.5

Source: Government of India Ministry of Community Development and Cooperation's Cooperative Movement in India, Important Statistics, 1961-62, p. 18.

As already stated, in 1950-51, the total number of primary land mortgage banks in India was 286; however, in 1961-62 this number had increased to 535. The rise in the membership of these banks has been more rapid. Whereas the membership in 1950-51 was 2.15 lakhs, in 1961-62, it had risen more than three times to 8.52 lakhs. The most impressive increase seems to have occurred in the working capital of the primary land mortgage banks. Whereas in 1950-51, this capital was Rs 6.6 crores, in 1961-62 it was Rs 38.42 crores. The increase in the share capital of the primary land mortgage banks has also been rapid though not as rapid as that in the working capital. In 1950-51, the share capital of the primary land mortgage banks in the country was 0.52 crores but in 1961-62, it had gone up to Rs 2.82 crores.

The increase in the loans advanced by primary land mortgage banks has been about ten fold for whereas in 1950-51, the total amount of loans given by these banks was only Rs 1.29, crores in 1961-62, it was Rs 12.58 crores. The increase in the loans of the primary land mortgage bank has been particularly marked since about the middle of the Second Plan. But between 1960-61 and 1961-62 the increase was spectacular. From Rs 7.17 crores in 1960-61, the loans increased to Rs 12.58 crores in 1961-62, registering an increase of over 5.5 crores which is what we could not have during all the period between 1950-51 and 1960-61. The interesting thing is that the overdues have also risen with the increase in the amount of loans. As can be seen from the table, whereas these overdues constituted 1.3% of outstanding loans in 1950-51, they constituted 2.5% in 1961-62.

(Rupees in crores)

Year	Number	Membership: Banks and Societies	Membership: Individuals	Share capital	Debentures outstanding	Working capital	Loans advanced: Banks and societies	Loans advanced: Individuals	Loans outstanding: Banks and societies	Loans outstanding: Individuals	Of which overdues	Overdues as % of outstanding loans (%)
1	2	3	4	5	6	7	8	9	10	11	12	13
1950-51	5	398	9,450	0.51	6.75	7.72	1.24	0.09	5.65	0.33	0.01	0.1
1955-56	9	491	90,295	0.79	14.94	18.55	1.71	1.12	10.12	2.96	1.15	8.8
1956-57	14*	419	116,142	1.09	16.95	21.32	2.36	1.44	11.19	3.75	0.24	1.6
1957-58	17*	539	150,944	2.26	20.48	25.88	2.54	2.14	12.65	6.27	0.90	4.8
1958-59	17*	519	184,772	2.91	24.46	31.35	3.40	2.61	15.61	7.03	0.74	3.3
1959-60	18*	563	215,937	3.49	27.07	37.38	4.98	3.54	18.55	9.95	1.05	3.7
1960-61	18@	696	273,795	4.33	36.53	47.60	7.18	4.45	23.53	13.98	1.22	3.3
1961-62	18	681	299,478	5.74	48.07	61.72	11.31	3.45	33.72	14.19	1.57	3.3

* Including land mortgage banking departments of 2 state cooperative banks.
@ Including land mortgage banking department of M.P. State Cooperative Bank.

Source: Government of India Ministry of Community Development and Cooperation's 'Cooperative Movement in India, Important Statistics, 1961-62', p. 12.

The central land mortgage banks have also shown considerable progress since 1950-51. Their number which was five in 1950-51 rose to 18 in 1961-62. The really impressive increase is in the membership of individuals. Whereus in 1950-51, individuals who held the membership of central land mortgage banks numbered 9450, in 1961-62 they numbered 2,99,478. The share capital of central land mortgage banks also rose over 10 times during this period. From ₨ 0.51 crores in 1950-51, it rose to ₨ 5.74 crores in 1961-62. The outstanding debentures which were ₨ 6.75 crores in 1950-51 rose about 7 times to ₨ 48.07 crores in 1961-62. Almost similar was the improvement in respect of working capital of the central land mortgage banks. In 1950-51, the working capital of these banks was ₨ 7.72 crores, but in 1961-62 it was ₨ 61.72 crores. The loans advanced by central land mortgage banks increased from ₨ 1.24 crores in 1950-51 (in case of banks and societies) to ₨ 11.31 crores in 1961-62. In the case of individuals, the increase was of the order of about ₨ 3.36 crores. In 1950-51, individuals got only about ₨ 0.09 crores but in 1961-62 loans advanced to them were at the figure of ₨ 3.45 crores. The picture in regard to overdues as per cent of outstanding loans is somewhat depressing. Such overdues constituted 0.1% of outstanding loans in 1950-51 and 3.3% in 1961-62. While the 1961-62 per-centage marks an improvement over the situation as it was towards the close of the First Five Year Plan (in 1955-56, the percentage was as high as 8.8), it still stands at a level which is much higher than that of 1950-51.

In the past, loans advanced by the land mortgage banks were predominantly for the discharge of old debts. In the case of Mysore and Madras, loans given for the unproductive purpose of clearing

old debts were 100 and 95% respectively. Now, however, the emphasis is more on their being given for productive rather than for unproductive purposes.

The Reserve Bank of India seems to have taken thus far, more interest in short and medium term loans than in the long term loans financed by the land mortgage banks. It subscribes to the debentures of land mortgage banks to the extent of 10%, and that too, if the debentures remain unsubscribed by the public.

The land mortgage banks raise their working capital from shares and debentures floated by them from time to time. The difference in the present rate of interest allowed by the Government on their paper and the debentures of the land mortgage banks is only ½%. The terms and conditions of floatation of debentures of the land mortgage banks are subject to the approval of the Reserve Bank of India.

The Reserve Bank underwrites nearly 50 per cent of each issue. Land mortgage banks are allowed to raise their debentures at not less than 4½ per cent or so. Their working expenses are often high on account of meagre turnover. Consequently, the economic lending rate of a primary society has to be above 7½ per cent. Now with such a high rate of interest, with depreciation at 5 to 7½ per cent and with so much working cost to utilise the improvement (financed through long term loans) including expenses over electricity, steam or bullock power in using well water, for example, the entire scheme, does not, by and large, sound a business proposition for every cultivator. All places, this rate of interest is subsidised but the reduction caused by that subsidy is not adequate.

If we were to look to the figures relating to the supply of short term and long term finance through cooperatives we would discover that the long term finance has not constituted that proportion of the short term finance which it should constitute at least in the earlier stages of development of the rural economy.

Relative positions of short term, medium term and long term cooperative finance in the rural sector.

(Rupees in crores)

Year	Short term funds	Medium term	Total	Long term	Loans advanced by central mortgage banks to individuals	Total of long term finance
1957-58	82.59	13.46	96.05	2.52	2.14	4.66
1958-59	110.77	13.43	124.20	3.27	2.61	5.88
1959-60	154.01	15.05	169.06	5.10	3.54	8.64
1960-61	182.82	19.93	202.75	7.17	4.45	11.62
1961-62	205.18	22.90	228.08	12.58	3.45	16.03

Sources: (i) Reserve Bank's 'Statistical Statements Relating to the Cooperative Movement in India, 1961-62'.
(ii) Community Development and Cooperation - High lights of the Programme, February, 1964.
(iii) Co-operative Movement in India - Important Statistics, 1961-62.

Short, Medium term and Long term Credit in the Rural Sector as a percentage of the total

Year	Total credit (in Rs crores)	Short & Medium term credit as per cent of (2)	Long term credit as per cent of (2)
1	2	3	4
1957-58	100.71	95.37	4.62
1958-59	130.08	95.47	4.52
1959-60	177.07	95.13	4.86
1960-61	214.37	94.57	5.42
1961-62	244.11	93.43	6.56

While it is true that long term credit in the rural sector is now a higher percentage of the total than what it was earlier, it is still a rather small percentage. In 1957-58, long term credit was 4.62 per cent of the total; in 1960-61, it was 5.42 per cent; a year later it was still higher, that is, 6.56 per cent. But in contrast, the percentages relating to short and medium term credit have been very much higher. Throughout the years referred to in the table, short and medium credit was more than 93 per cent of the total credit made available to the rural population.

There may be many factors responsible for this state of affairs. There may, for example, be the problem of finding good borrowers or of general apathy and indifference of State Governments towards land mortgage banks.[1] There may also be paucity of trained personnel. But the most important factor is the inadequacy of funds which the land mortgage banks have at their disposal.

We have already referred to the establishment of Agricultural Refinance Corporation on July 1, 1963. This Corporation has, in the first year of its existence, agreed to finance three schemes of land reclamation and development in Andhra Pradesh and one for the development of Coconut plantation in Orissa through purchase of special development debentures to be floated by the central land mortgage banks in that connection to the extent of Rs 244.80 lakhs, i.e., 90 per cent of the total financial outlay in each case.[2] The

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1. 'Problems of Newly Organised Land Mortgage Banks'; Rauf Jafri (President, U.P. State Cooperative Land Development Bank), <u>The Leader</u>, October, 25, 1964.
2. Chairman's Speech, R.B.I. Bulletin, September, 1964, p. 1159.

balance of 10 per cent is to be taken by the States. Though the Board of the Corporation has a right to insist upon a 25 per cent contribution from the States, it can relax the condition in appropriate cases.

The States provision of long term finance is limited and is given in the form of taccavi loans. The gross amount of these loans outstanding on June 30, 1957 was 94 crores and remained at this level a year later. That the fresh advances by way of taccavi as well as recovery against the outstandings amounted to about Rs 17 crores in the year 1958 shows how limited has been the State provision of long term finance to the rural sector. Even here, most of what is given is, as has been already pointed out, distress rather than development finance.

The First All-India Central Land Mortgage Banks Association[3] had felt that Life Insurance Corporation of India should provide at least 30% of the funds required by land mortgage banks. In respect of commercial banks' contribution, it was suggested that they might buy debentures worth Rs 40 crores. While the debentures of land mortgage banks are freely accepted by the State Bank of India for credit accomodation, it might be helpful if they are classed with Government and allied securities rather than with the debentures of joint stock companies.

As for the contribution of the cooperative banks themselves, to the financing of the debentures of land mortgage banks, the

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3. Memorandum submitted on behalf of the Standing Committee of the All-India Central Cooperative Land Mortgage Banks Association to the National Cooperative Development and Warehousing Board, New Delhi, All-India Cooperative Review, May, 1960, pp. 98-102.

Association felt that they could, especially in view of the fact that their income from this investment would be exempted from income tax (a cooperative bank's income from another is exempted from income tax) provide a sum of ₨ 25 crores.

The State and Central Governments should provide ₨ 50 crores; if necessary they might arrange for contribution from the United States Food Loans Fund (PL 480 funds).

In view of the fact that it might be desirable to establish a primary land mortgage bank or a branch of central land mortgage bank in each taluka, the Association suggested that some 500 new primary land mortgage banks or branches of central land mortgage banks should be organised so that by 1965-66, the country has about 1,000 of these units serving the long term financial needs of our farmers.

In this expansion lot of expenditure is involved. The following table worked out by the Association gives an idea of the subsidy which the Government will have to provide for opening new primary land mortgage banks or new branches.[4] Subsidy will also be needed for the losses which some of these banks will incur in the earlier stages of their growth.

	(₨ crores)
1. Subsidy to 500 primary land mortgage banks or branches of central land mortgage banks at ₨ 10,000 per annum per unit for five years	2.50
2. Subsidy to 10 central land mortgage banks at ₨ 25,000 per annum for five years	0.12
3. Provision for losses	2.00
	4.62

4. Ibid.

The State Governments' contribution to the share capital of the land mortgage banks calculated for 500 new units at the rate of ₨ 40,000 per primary bank or additional branch of a central land mortgage bank, would be ₨ 2 crores.

There should also be an attempt to channelise all long term credit through cooperatives or at any rate, there must be proper coordination between the various agencies supplying long term finance to the rural sector.

As we think of the recommendations of the Trust, All-India Central Land Mortgage Banks' Association, we might note two outstanding things about the position of land mortgage banks in the country, namely,

(1) that the debentures have been the principal source of finance for the central land mortgage banks;

(2) that the borrowings from central land mortgage banks have been the principal source of finance for the primary land mortgage banks.

In case of the latter, debentures were almost altogether absent and deposits from individuals were nearabout 1% of their total working capital.

There is no doubt that, as the land Mortgage Bank's Association has itself underlined, efforts should be made to get institutions - cooperatives[5] and others, with surplus funds and liquid assets -

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5. The Standing Advisory Committee on Agricultural Credit has, following a resolution of the All-India Central Land Mortgage Banks' Conference held in 1964 recommended that up to 60 per cent of the Sinking funds of Central land mortgage banks might be invested in the debentures of such banks. The National Cooperative Development Cooperation has decided that they might purchase debentures of central land mortgage banks of States which are relatively backward in respect of long term finance.to the extent of 7½ per cent of the amount issued in each series during 1964-65. Both these measures are intended to step-up the contribution of the cooperatives to long term finance in the rural sector. (R.B.I. Bulletin, August, 1964, p. 1030).

interested in subscribing to the debentures of the land mortgage banks. It is a little surprising that this interest has not developed to the extent it should, despite the fact that the debentures are fully guaranteed by the State Governments and that all financing institutions would be willing to advance loans against their security.

However, as far as possible those are the non-institutional investors who should be persuaded first to buy these debentures. After all with the various plans of rural development the earnings of at least, some sections of the rural community have, certainly, been rising. With increase in the monetisation of the rural economy and the flow of funds in the rural sector, it should be possible for the land mortgage banks to popularise investment in their debentures amongst the prosperous sections of the rural population.

It is noteworthy that of the Rs 66.83 crores of loans outstanding as on 30th June, 1963, as much as Rs 60.88 crores was in respect of the land mortgage banks in Gujarat, Maharashtra, Andhra Pradesh, Madras and Mysore.[6] Banks in these five States had accounted for a major portion of the long term cooperative agricultural credit in the past also. On the other hand, in the eastern States of Assam, West Bengal, Orissa and Bihar and in the Northern States of U.P., Rajasthan and Punjab the progress has been rather poor.[7] This lack of balance in the growth of cooperative credit might be partly due to the fact that the backward States have more legislative restrictions on the transferability of rights for loan, greater undertainty

6. 'State Land Mortgage Banks in India'; P.C. Bhattacharya, Journal of the Indian Institute of Bankers, January, 1964, p. 19.
7. Ibid.

as to the future policy of the State Government concerned in respect of land reforms, inadequate trained and qualified staff and risky character of agricultural operations. However, some of these factors can and must be improved if cooperative credit is to have a uniform growth all over the country.

One does not know whether the Government is really clear about its policies in regard to the supply of long term finance in the rural sector. Some times one gets the impression that the Government desires that such supplies may not be entirely necessary in view of the Government itself undertaking investment in the infra-structure of the rural sector. In fact, in those areas where with the help of the Ford Foundation, what are known as 'package programmes' are being implemented, the needs of finance, calculated on the basis of farm plans, relate largely to short and medium term funds rather than long term funds. The assumption, probably, is that in the matter of long term finance, nobody needs to bother much except the Government. In a way what the Government proposes to do may be right but the merit of Government decision can be judged only by reference to their basic socio-economic policy towards economic problems of the rural sector. If their emphasis is more on inducement and less on coercion, more on cooperation and less on imposition, we may have to revert to a position where the land mortgage banks will have to be the principal source of long term finance in the rural sector and they would have to be greatly revitalised if they have to discharge their obligations effectively. The total resources of the land mortgage banks are no where near what they should be in the light of needs of long term finance of the farming population.

CHAPTER 20

RESERVE BANK OF INDIA AND RURAL CREDIT

The interest of the Reserve Bank of India in cooperative credit dates back to the time when the Bank was founded. Section 54 of the Reserve Bank of India Act, 1934 required the Bank to create a special Agricultural Credit Department which would maintain an expert staff to study all questions of agricultural credit and be available for consultation and to coordinate the operations of the Bank in connection with agricultural credit and its relations with State cooperative banks and other organisations engaged in the business of agricultural credit.

At the beginning, the Reserve Bank was more concerned with the giving of advice on agricultural finance than with actually supplying finance to the agricultural sector. This was because the Bank's finance could, by and large, be channelised through State cooperative banks and central cooperative banks which did not mostly come up to the requisite standard.

But between 1948-49 and 1958-59, the sum which the State Cooperative banks owed to the Reserve Bank increased from half a crore of rupees to Rs 62 crores. An idea of the growth of the Reserve Bank's interest in rural credit can be had from the following tables.

Table 1

Short-term loans from the Reserve Bank for Seasonal Agricultural Operations and Marketing of Crops.

(Rs lakhs)

Year (July - June)	Amount sanctioned	Amount outstanding
1948-49	180.25	57.01
1949-50	214.00	127.50
1950-51	762.00	315.00
1951-52	1240.00	645.29
1952-53	1242.39	679.62
1953-54	1632.15	856.54
1954-55	2120.55	811.16
1955-56	2963.50	1298.30
1956-57	3525.00	2332.39
1957-58	4824.35	4047.35
1958-59	6542.55	5626.81

Table 2

Medium-Term Loans from the Reserve Bank for Agricultural Purposes

(Rs lakhs)

Year (July - June)	Amount sanctioned	Amount outstanding
1954-55	121.86	22.18
1955-56	139.67	98.82
1956-57	167.00	158.22
1957-58	772.00	342.47
1958-59	452.05	577.19

Table 3

Long-term loans from the Reserve Bank to State Governments for Contribution to the Share Capital of Cooperative Credit Institutions.

(Rs lakhs)

Year (April - March)	Amount sanctioned	Amount drawn
1956-57	268.20	160.45
1957-58	606.98	583.39
1958-59	604.57	574.49
1959-60	494.39	493.34

Source: 'The Role of the Reserve Bank of India in the Development of Credit Institutions': B. Venkatappiah, Reserve Bank of India Bulletin, January 1961, pp. 22, 23.

In respect of the short-term loans for seasonal agricultural operations and marketing of crops, the help given by the Reserve Bank has multiplied significantly. From Rs 180.25 lakhs in 1948-49, it short up to the big sum of Rs 6542.55 lakhs in 1958-59.

However, the increase in medium term loans has not been so spectacular. From Rs 121.86 lakhs in 1954-55, medium term loans for agricultural purposes rose to Rs 772.00 lakhs in 1957-58. In fact the year 1958-59, actually saw a decline in the amount of these loans.

In the matter of the long term loans, the Reserve Bank normally helps the State Governments in making contributions to the share capital of cooperative credit institutions. This help was of the order of Rs 268.20 lakhs in 1956-57 and Rs 606.98 lakhs and Rs 604.57 lakhs in 1957-58 and 1958-59 respectively. In 1959-60, the long term loans from the Reserve Bank to State Governments declined to Rs 494.39 lakhs possibly because State Governments were thinking of some other methods of financing long term investment in the agricultural sector.

The principal change that has occurred is that the Reserve Bank does not remain contented with mere advice; it collaborates with the institutions connected with rural credit including the borrowing banks in a programme for rendering the borrowing structure efficient and increasingly credit worthy.

The first step which the Reserve Bank took was to look into the procedural difficulty which stood in the way of even efficient cooperative banks borrowing more respectable sums from the Bank. It was felt that the period of repayment of nine months for which the loans were paid and the time-end of September each year by which the loans

were to be repaid, should not be rigidly adhered to since seasons and duration of crops differed as between different regions and so a number of procedural changes were made because of which larger loans for agricultural operations began to be drawn.

The second step was to conduct a survey of rural credit and act broadly according to the findings of the survey. The Committee of Direction of the All-India Rural Credit Survey suggested an integrated scheme of rural credit whose main features were to be: (i) state partnership at different levels to the extent needed; (ii) development along with credit, of marketing, processing, warehousing and storage facilities; and (iii) extensive provision of training facilities.

State Bank of India and Cooperative Credit

In consequence of the recommendation of the Committee of Direction of the All-India Rural Credit Survey suggesting State partnership, the State Bank of India was established on 1st July, 1955. A primary purpose of the State Bank was to create conditions leading to the emergence of such commercial banking in the rural sector as was responsive to the needs of cooperative institutions, specially in the field of processing and marketing. The bank was to help in easy remittance facilities and in its loan operations to follow a policy which agreed with sound banking principles and at the same time enabled implementation of national policies as laid down by the Government and the Reserve Bank of India.

The ad hoc Committee on the role of the State Bank of India vis-a-vis cooperative and agricultural finance set up by the Reserve Bank of India in March 1957, had said that '......... in those States where cooperative banks are able to command sufficient re-

sources for financing cooperative marketing and processing units, e.g., Andhra, Madras and Bombay and where the financing of these activities is already taking place without much difficulty, it is only natural that the State Bank's role in this context need not be as large as in other cooperatively less developed States. In other words, the State Bank's participation will be for the definite purpose of adding to resources hitherto available to the sector of cooperative marketing and processing and the need for such supplementing of resources arises particularly in States where the cooperative banking structure is weak and unable to meet the needs of agricultural production credit as well as marketing credit adequately.'

In short, the State Bank's presence is to be encouraged only where it strengthens the building up of cooperative finance.

Within five years of its establishment, the State Bank opened more than 400 branches and a majority of these branches were opened in rural and semi-urban areas.

According to the relevant statutes, not less than 55% of the share capital of the State Bank shall be held by the Reserve Bank. In actual fact, a much larger share capital of the State Bank is owned by the Reserve Bank today. The dividend due to the Reserve Bank on 55% of the share capital is, in accordance with the statute, placed in a fund called the Integration and Development Fund. This is available for meeting such losses as may accrue to the State Bank in respect of the new branches opened by it.

In regard to the remittance facilities offered by the State Bank, by 1961, the bank had increased free remittances from State Cooperative Banks and their affiliated central and industrial co-

operative banks from any branch of the State Bank to the principal accounts maintained by them with the Reserve Bank of India from 1 to 3 a week. The cooperative central financing agencies including their apex banks are allowed free remittance once a week to their up country branches. In addition, cooperative banks can remit money through the State Bank at a certain premium. The total remittances issued by the State Bank of India on behalf of cooperative institutions under the Reserve Bank of India Remittance Facilities Scheme increased from Rs 54.4 crores in the cooperative year 1957-58 to Rs 94.0 crores in 1959-60 and under the State Bank's own scheme from Rs 29.9 crores in 1957-58 to Rs 65.9 crores in 1959-60.

In the matter of credit, cooperative institutions can borrow and take overdraft against government securities at a rate which is ½% lower than the State Bank of India Advance rate. Sometimes, on the basis of government guarantee, they are given advances to finance their affiliated cooperative institutions. Cooperative banks' own cheques are collected or purchased at concessional rates. Such drafts or cheques as the cooperative banks draw on apex banks for replenishing funds are discounted by the State Bank at concessional rates. From Rs 8.5 crores on September 30, 1957, the limit of loans granted by the State Bank against Government securities rose over 40% to Rs 11.4 crores on 31st May, 1961.

By 1965, the State Bank would be having about 1700 branches or offices all over the country and would be even in a better position to help the growth of cooperative finance.

The State Bank helps land mortgage banks directly by subscribing to the debentures issued by the central land mortgage banks in

the country. The bank's holding of such debentures increased from Rs 5 lakhs at the end of 1955 to Rs 134 lakhs at the end of May, 1961. Indirectly, it helps by accepting debentures as eligible securities for granting advances to cooperative institutions and other holders of these debentures. By May 1961, the State Bank of India had sanctioned limits of Rs 56.3 lakhs against the debentures of land mortgage banks. The State Bank also helps against government guarantee by giving interim accommodation to land mortgage banks when they are short of funds till such time as they are able to get funds through issue of debentures. As on 31st May, 1961, the bank had, for example, sanctioned up to Rs 50 lakhs as interim accommodation to a certain central land mortgage bank in the country.

State Bank and Finance For Marketing and Processing in the Rural Sector

The Second Five Year Plan had aimed at bringing about 10% of the marketable surplus in agricultural sector within the orbit of cooperative marketing. At the end of the Third Five Year Plan, marketing societies are expected to handle about 20% of the marketable surplus in foodgrains and about 30% of the marketabele surplus in commercial crops. In the field of processing, about 25 cooperative sugar factories and 783 other processing societies are proposed to be set up.

The State Bank's participation in marketing and processing societies has not been very substantial. As at the end of May, 1961, the bank had sanctioned limits of Rs 251.1 lakhs to 173 marketing and processing societies other than sugar factories and

the outstandings stood at Rs 49.2 lakhs. In respect of sugar factories, the bank had, pending receipt of loans from the Industrial Finance Corporation of India, granted interim accommodation to four sugar factories of the order of Rs 115 lakhs (outstandings Rs 69.3 lakhs). Two sugar factories had been sanctioned limits of Rs 60 lakhs (outstandings Rs 55.1 lakhs) by way of clean loans for working capital purposes against government guarantee and seven sugar factories had been sanctioned pledge loans of Rs 335 lakhs (outstandings Rs 247 lakhs).

Up till May 1961, the State Bank had granted 3973 advances against warehouse receipts, the limits and outstandings in respect of these advances being Rs 4.5 crores and Rs 2.4 crores respectively.

As marketing and processing societies and warehousing facilities grow, the State Bank's role in financing them would increase with time.

In the matter of State partnership, while the Reserve Bank and the Central and State Governments all had a responsibility, it was the State Government which was expected to legislate about, administer and subsidize the cooperatives. And for this, it was provided that the State governments could borrow long term loans from the Reserve Bank if they desired to take shares in a cooperative bank or society or from the National Cooperative Development Board if they wished to become partners in marketing or processing societies.

The Reserve Bank of India Act was amended to provide for a Long-term Operations Fund built up from part of the profits otherwise transferable to the Central Government. Loans for a period

ranging between 1 to 20 years could be advanced to the State Governments for their shares either directly in a society or a bank or where appropriate, indirectly through the apex bank. Up to March 31, 1960, the Reserve Bank had sanctioned loans fof the order of Rs 80 crores.

In the matter of short-term accommodation to cooperative banks, the Reserve Bank helps by way of re-imbursing or re-financing rather than direct financing. Where the banks wanting accommodation are strong, they are required, apart from the paper they offer, to get the endorsement of two sound cooperative banks including an apex bank. Where the banks wanting accommodation are weak, but in the process of gaining strength, they have, in addition, to produce a guarantee from the State Government. Further, the Reserve Bank applies special criteria relating to the lending programmes of the cooperative banks such as whether their loans are being properly supervised, whether they are being repaid in time, whether the accounts of the banks are properly audited, whether the banks have the right of amount of share capital and other owned resources, whether the loans are or are not being given for productive purposes, etc.

The Reserve Bank lends to cooperative banks at a rate of interest which is 2% lower than the Bank Rate.

The entire aim of the Reserve Bank's interest is to help cooperative banks command their own resources so that they are eventually able to stand on their own legs as sound financial institutions in the rural sector.

We will refer to the place of rural finance in the development of the agricultural sector later again. Here we might only

point out that cooperative institutions cannot stand on their own legs unless there is a bold programme of mobilisation of rural savings through cooperatives.

An important element in that mobilisation would be the rate of interest which the cooperatives offer on their deposits. For a considerable proportion of the rural population which is too poor to save, this rate of interest, would, of course, not matter. For others who are engaged in speculation, it may matter to the extent to which the rate of return on speculation does not very much exceed the rate of interest. On the other hand, with such sentiment involving assets as gold or cattle, the position would not be quite predictable. However, for one rather obvious reason the case for upgrading rates of interest on cooperative deposits would still be worth pressing. It is that if a certain level of deposit rates has to be there in order to induce rural people to save, a level higher than the present one, assuming no particular change in their asset preferences, should be more helpful.

If we look at the rates of interest which are offered on co-operative deposits, we will find that they are not very different from those which are offered by the commercial banks.

In 1962, whereas the scheduled bank's savings deposits rates ranged between 1½ and 3¾ per cent and non-scheduled banks' between 1½ and 4½ per cent, the savings deposits rates of State Cooperative banks and Central cooperative banks ranged between 2 and 3½ per cent and 1½ and 3½ per cent respectively. The savings deposits rate most common with scheduled and non-scheduled banks and state and central cooperative banks was 3 per cent.[1] In the case of fixed deposits, the rates ranged between 3 to 5½ per cent for scheduled banks, 1½ to 6½ per cent for non-scheduled banks, 2 to 5¼ per cent for state cooperative banks and 1½ to 6 per cent for central cooperative banks. For most, maturity periods, the commercial banks' fixed deposit rates were higher than those of the cooperative banks.[2] Only on deposits maturing after three years were the rates more or less the same in both the commercial banks' and the cooperative sectors.

Now in rural areas, we know, the return available to lenders is not only very much higher than that on cooperative banks' fixed deposits, it is very much higher than what lenders are able to procure in the urban areas. It is estimated that till some years ago, the usual money lenders' rate of interest in India could go up as high as 50 per cent per annum while the exceptional rate (which would refer to the rate on loans constituting less than 5 per cent of the total loans granted) would range between 300 and 400 per cent.[3] Therefore, whatever may be the justification behind

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1. 'Deposit Rates of Cooperative Banks, June 1962', R.B.I. Bulletin, September 1964, p. 1149.
2. Ibid.
3. 'Interest Rates Outside the Organised Money Markets of Under-developed countries', U Tun Wai, I.M.F. Staff Papers, November, 1957, p. 140.

keeping interest rates on commercial banks' deposits on a particular level, there seems no point in letting interest rates on cooperative banks' deposits remain at the same level. And if rates on cooperative banks' deposits are lower, the picture is even more disappointing. There is, thus, room for upgrading deposit rates in the cooperative sector. In fact, if cooperatives have to be made increasingly self-reliant, one wonders if one can think of any other alternative.

As we have seen earlier, the subscription of individuals to the debentures of the central land mortgage banks or even to the share capital of the primary land mortgage banks or primary credit societies is not as much as it should be. Hows long can the Reserve Bank of India go on making funds available to the cooperatives? For, apart from the fact that such funds come in the way of cooperatives making their own efforts in the direction of mobilising savings, they tend to expand money supply in the rural sector and (produce) more or less the same sort of inflationary impact[4] which expansion of money supply in the industrial sector does. In under-developed countries, the elasticity of supply of output in the rural sector is even less than what it is in the industrial sector. Moreover, as we have seen in our analysis above, such increase in money supply is gravitated towards people with speculative motive and

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4. '........ there are issues more immediately connected with the role of the Reserve Bank in rural credit. One of these is the question of the possibility of the inflationary pressures in the economy being increased as the result of a rapid expansion of cooperative credit based in large part on loans obtained from the Reserve Bank'; Shri B. Venkatappiah, Deputy Governor, Reserve Bank of India, R.B.I. Bulletin, January 1961, p. 20.

enable them to withhold larger stocks from the market. On the other hand, the rise in prices which all this occasions, leads to a deficiency in the transactions cum precautionary balances of the small cultivation and compels them to borrow. This puts a pressure upon the interest rates to rise. Therefore, increased money supply in the rural sector does not, as we have already argued, necessarily lead to a reduction in the rate of interest charged on loans available from non-institutional sources. Nor does it lead to the expected expansion in output which is our ultimate objective.

CHAPTER 21

CREDIT POLICY FOR THE RURAL SECTOR

The All-India Rural Credit Survey had suggested that the average amount borrowed by cultivating families during the years covered by the General Schedule was Rs 210.[1] A Reserve Bank Survey suggests that during 1961-62, the borrowing per cultivator household was Rs 205.[2] Even if we allow for the differences in the concepts and definitions which the Reserve Bank Survey refers to, the average improvement in borrowing appears to be very little. This is not to say that the total borrowing of the agricultural sector or the total credit advanced to that sector, has remained stationary. But the borrowing per household amongst the cultivators does not appear to have registered any marked increase over the last few years.

However, the borrowing per household amongst non-cultivators has increased. The average borrowing per non-cultivator household mentioned by the All-India Rural Credit Survey was Rs 66, that mentioned by the Reserve Bank Survey is Rs 111.

According to the Reserve Bank Survey, the average borrowing of the reporting households is Rs 393 for cultivators and only Rs 270 for non-cultivators. The average borrowing of all households

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1. Report, 1967, Vol. I, Part 2, p. 1.
2. 'All-India Rural Debt and Investment Survey, 1961-62', R.B.I. Bulletin, December, 1963.

put together is Rs 205 for cultivators but slightly more than half this amount for the non-cultivators. For cultivators and non-cultivators, reporting and non-reporting households put together, the average borrowing is Rs 180.

The Reserve Bank Survey brings out the fact that the borrowing households are unable to pay off even the debt which is currently contracted.

The position in regard to borrowing and repayment is indicated by the following table.

Borrowing and Repayments

	Borrowing			Repayments		
	Proportion of households reporting per cent	Average per reporting household Rs	Average per household Rs	Proportion of households reporting per cent	Average per reporting household Rs	Average per household Rs
Cultivators	52.1	393	205	36.0	282	102
Non-cultivators	41.1	270	111	24.1	245	59
All rural households	49.1	366	180	32.8	275	90

Source: 'All-India Rural Debt and Investment Survey, 1961-62', R.B.I. Bulletin, December, 1963.

For reporting cultivator households, borrowing is Rs 270 but repayment is Rs 245. Incidentally, the deficit in repayment is larger for cultivators than for non-cultivators. Comparing average borrowing and repayment per household, we find, for the cultivators that whereas the sum borrowed is Rs 205, the sum repaid is Rs 102;

for the non-cultivators whereas the sum borrowed is Rs 111, that repaid is Rs 59. For all rural households, average borrowing is Rs 180, average repayment is Rs 90. And so we can conclude that approximately half the debt which is currently contracted remains unpaid and the arrears of debt tend to increase with time.

This naturally handicaps further borrowing by the cultivators and results in slow capital formation in the rural sector.

Estimates of Fixed Capital Formation

(In rupees per household)

	Fixed capital formation in farm business	Fixed capital formation in non-farm business	Major alterations, additions and new construction of residential houses	Total
Cultivators	32	4	27	63
Non-cultivators	1	4	9	14
All rural households	24	4	22	50

Source: Reserve Bank of India Bulletin, December, 1963.

The fixed capital formation amongst non-cultivator households in farm business is negligible while that amongst cultivators is Rs 32 per household. Fixed capital formation on the non-farm business is, however, the same for cultivators as well as non-cultivator households. A notable feature of capital formation in the rural sector is the expenditure on major alterations, additions and new construction of residential houses. Such expenditure, in case of small cultivators, is, only a little less than that on fixed capital formation in farm business while, in case of non-cultivators, it is much more than the expenditure on fixed capital

formation in non-farm business.

To come to the other side of the picture, the Central Board of Directors of the Reserve Bank of India reporting on cooperative finance observe, "The absorptive capacity of the credit structure did not seem to keep pace with the rising quantum of credit forthcoming from the Reserve Bank. Thus, the proportion of maximum outstandings to the total credit limits sanctioned by the Reserve Bank for short-term agricultural purposes continued to fall from year to year declining from 90 per cent of the total limits in 1960-61, to 84 per cent, 81 per cent and 79 per cent in the last three years respectively."[3] The position in respect of medium term loans was no better. During 1963-64, withdrawals on medium term loans constituted only 53 per cent of the loans sanctioned.[4]

This is obviously not a happy state of affairs if we remember that India's agricultural production in 1962-63 was only 36.8 per cent higher than what it was in 1949-50.

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3. R.B.I. Bulletin, August, 1964, p. 1031.
4. Ibid.

Index numbers of Agricultural Production in India - Groups and Commodities

(Agricultural year 1949-50 = 100)

	Food grains	Non-food grains	All commodities
1950-51	90.5	105.9	95.6
1951-52	91.1	110.5	97.5
1952-53	101.1	103.8	102.0
1953-54	119.1	104.7	114.3
1954-55	115.0	120.9	117.0
1955-56	115.3	119.9	116.8
1956-57	120.8	131.5	124.3
1957-58	109.2	129.5	115.9
1958-59	130.6	139.4	133.5
1959-60	127.9	135.0	130.3
1960-61	135.6	147.9	139.7
1961-62	137.5	149.2	141.4
1962-63	131.3	148.0	136.8

Note: The indices for 1960-61, and 1961-62 are generally based on partially revised estimates while those for 1962-63 are generally based on Final Estimates. The indices for these years are, therefore, subject to revision.

Source: Agricultural Situation in India, August, 1963.

Between 1949-50 and 1962-63, the average annual rate of growth of agricultural output was not very much higher than the average annual rate of growth of population and of agricultural and non-agricultural employment. During the first decade of planning, population grew at the annual rate of 2.1 per cent but currently it might be going up at a much higher rate. The estimated achievement on the employment front during the first two

plans, i.e., from 1951 to 1961, corresponds to an annual rate of growth of 2.5 per cent for non-agricultural employment and 0.3 per cent for agricultural employment.[5] The targets set for the Third Plan correspond to an annual rate of growth of employment of 3.5 per cent outside agriculture and of 0.4 per cent within agriculture. Between 1951-1976, rise in employment in India should approximate a compound rate of increase of 4 per cent per annum of non-agricultural employment and one per cent of agricultural employment.[6]

Employment increase in India - Achievements and Planned Targets

Period	Achievements and targets	
	Agriculture	Non-agriculture
	A. Million	
1951-56	1.5	5.5
1956-61	1.5	6.5
1961-66	2	10
	B. Percentage annual compound rate of growth	
1951-56	0.2	2.5
1956-61	0.3	2.6
1961-62	0.4	3.5

Source: Economic Bulletin for Asia and the Far East, United Nations, September, 1961, p. 19.

The importance of a rapid growth of agricultural production is too well known to be emphasised.

Applying the formula that the proportion of the labour force engaged in non-agricultural activities is a linear function of

5. Economic Bulletin for Asia and the Far East, United Nations, September, 1961, p. 19.
6. Ibid.

the logarithm of agricultural productivity (measured a head of the agricultural population and including mining and forestry with agriculture) to India, Professor Colin Clark observes: "With population growing at 2 per cent a year and total agricultural product growing on the average (subject to very considerable annual variations) at 3 per cent a year, it is found that non-agricultural employment can only grow at a rate slightly less than 3 per cent a year. It will grow faster than total population and the proportion of non-agricultural employment will increase, but only slowly.'[7]

If employment in India is to grow at a rate which reduces the backlog of our unemployment(this back log has been rising in the sense that at the beginning of each Five Year Plan it is greater than what it was at the beginning of the preceding one) and if economic development generally has to be accelerated, agricultural production must rise faster than the rate reflected in the above table.

The rural credit policy which has been pursued thus far has bothered more about availability of credit and less about its proper utilisation. However, without a proper utilisation of credit even whatever is available, may not, as we have just seen, be used up.

We have already suggested earlier that the cultivators in rural areas, well behind the poverty barrier, borrow to make up deficiency in their transactions balances (which are predominantly consumption balances) and keep up the pressure on interest rates.

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7. 'The Factors Hampering Indian Economic Growth', Capital, 19th December, 1963, p. 15.

Institutional credit can extricate them out of the vicious circle only by helping to raise productivity of their farms. But raising this productivity is not a matter of just making funds available. That could have worked if lot of land was idle and all that the cultivator needed to do was to extend the use of the same technique and the same inputs to further investment. In situations where production cannot rise except through intensive cultivation and where we have to think in terms of new techniques and new inputs, that is, in terms of tractors rather than ploughs, in terms of sprayers, pesticides, fertilisers etc., it will not be enough to put finance into the hands of the illiterate cultivators. Neither the fact that productivity of Indian agriculture can improve only through intensive application of new and better inputs nor that it needs badly to be raised can be questioned.

Index of productivity on Acre

(1949 - 50 = 100)

Year	All crops	Foodgrains	Non-food grains
1949-50	100.0	100.0	100.0
1950-51	95.5	92.3	94.4
1951-52	96.1	93.2	90.4
1952-53	97.1	98.3	89.0
1953-54	193.1	108.4	90.0
1954-55	104.6	108.5	93.6
1955-56	101.9	103.4	90.8
1956-57	106.6	107.4	95.9
1957-58	101.1	98.6	95.2
1958-59	111.7	112.9	100.6

Source: 'Agricultural Progress Hinges on Greater Productivity': V.G.R. Aiyer, Supplement to 'Capital' of 20th December, 1962, p. 85.

As the above table shows, in respect of non-food grain crops, the productivity in 1958-59 was almost the same as it was ten years ago. On the other hand, the increase in the case of food-grains is not impressive at all. In fact, in view of the very considerable fluctuations in this productivity in the earlier years, we cannot be sure that it would not decline again.

The average productivity level in India's agricultural sector would roughly be only one-third of comparable countries like Egypt and Indonesia. The productivity rate in sugar-cane is reported to be only 20 per cent of what it is in Hawai, in rice, 29% of that in Japan, in wheat, 19% of that in Belgium, in maize, 17% of that in Belgium, in cotton, 22% of that in America and in milk, 5% of that in Holland.[8]

Within the country itself, there is a considerable divergence between one region and another. The productivity of rice in South India is estimated to be twice that in Uttar Pradesh. Productivity rate of cotton in the Punjab is over six times that in Madhya Pradesh.[9]

Now not knowing about the new inputs and how to use them and being extremely poor and custom ridden, an average cultivator is prone to misuse the funds that are made available to him in consumption and on religions and social ceremonies. The more he misuses these funds, the less does his output improve, the more he is unable to repay what he has borrowed and the more he is prevented from utilising what is available from the institutional sources.

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1. 'Raising Agriculture Productivity in India'; A.N. Rajamani, Capital, 19th December, 1963, p. 147.
2. Ibid.

That is why despite all the measures that have been taken, 'the farmer is still basing his financing mainly on the money lender'.[10]

Assistance in utilising credit, therefore, is perhaps, more important than supplying credit.

There is another reason why credit supply and credit utilisation should go together. Coordination between the two will force us to think of our limited inputs in the agricultural sector in a more calculated way and enable a better utilisation of those inputs than hitherto.

Take the important agricultural input, fertiliser, for example.

The consumption of fertiliser in India is poor even though it has been rising.

Country	Consumption a hectare in kilogram	Consumption a head in kilogram
India	2.7	0.9
Japan	270	17
West Germany	268	41
Netherlands	458	40
World average	22.2	12.2

Source: A Survey of Indian Industries, 1964: Raising Food Output Through Bigger Use of Fertilisers: John K. John, p. 14.

According to J.K. John, the country used 1.75 kilograms a hectare in terms of N, P & K in 1960-61, 2.25 kilogram a hectare in 1961-62 and 2.71 kilograms a hectare in 1962-63.[11] However,

10. 'Approach to Agricultural Development': C. Subramaniam, India's Minister for Food and Agriculture, Northern India Patrika, August 15, 1964.
11. Raising Food Output Through Bigger Use of Fertilisers, John K. John, p. 14.

of the total quantity of plant food (N : P_2O_5 and K_2O) distributed in the shape of fertilisers in 1962-63, i.e., 495,000 tonnes, only 25 per cent was applied to foodgrain crops while the rest went to plantation and cash crops such as tea, coffee, rubber, sugarcane and cotton. Assuming that one unit of plant food produces an additional 10 units of foodgrains, the increase in yield of foodgrains accounted for by fertiliser application in 1962-63 was no more than 1¼ million tons or 1.6 per cent of the total food-grains production.[12]

With planned credit, such misdirection of our limited inputs can be avoided.

There is evidence also to show that a coordination between credit supply and credit utilisation would assure encouraging results on the production front in the agricultural sector.

We have already referred to the supervised credit programme during Rabi 1957-58 to Kharif 1959 in the Mehrauli block about 9 miles South-West of Delhi.[13] This programme resulted in an increase in the average annual gross farm income of all the selected areas by Rs 247 or 16.6 per cent.

The more recent experience of the Intensive Agricultural District Programme[14] has also been quite encouraging. Under this

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12. Ibid.
13. See pp. 399-401.
14. This programme arose out of the report entitled 'India's Food Crisis and Steps to Meet It' submitted in April 1959 by an Agricultural Production Team sponsored by the Ford Foundation. The Team recommended that intensive efforts for production should be undertaken with a combination of all the technological improvements and concentration of manpower and resources in selected areas.
    The areas to start with were: Thanjavur (Madras), West Godavari (Andhra Pradesh), Shahabad (Bihar), Raipur (Madhya Pradesh), Aligarh (Uttar Pradesh), Ludhiana (Punjab) and

(Continued)

programme, credit is production-based and production-oriented and loans to participating members are sanctioned only against production plans. These plans take into account such factors for arriving at credit requirements as land and crop under cultivation, cost of implementing package of practices recommended, resources (in value) already available, value of crops to be raised and requirements in cash and kind (fertilisers, seeds, pesticides etc.).

According to the Expert Committee on Assessment and Evaluation of the programme,[15] there was a steady increase in the yield rates of wheat and barley in Aligarh in 1961-62 and 1962-63 over that in 1960-61. In the yield rates of bajra and maize, there was a large increase in 1962-63. In Ludhiana also, the yield rates of wheat and gram were considerably higher in the years 1961-62, and 1962-63 than in 1960-61. In Shahabad, the yield rate of rice for the year 1961-62 was 19 per cent higher than that for the previous year, although there was a fall in the rate during 1962-63 due to unfavourable weather. In Thanjavour, the yield rate of the Kuruvai crop steadily increased by about 1.2 quintals

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(Continued from previous page)

Pali (Rajasthan).

The distinctive feature of the I.A.D. Programme is the 'package' concept - the use in agriculture of inter-related factors, physical, social and institutional, in strategic combinations, which are likely to produce an impact on agricultural production in the programme areas.

The programme is based on voluntary acceptance by cultivators of the application of new technological practices for increasing output and farm earnings.

15. Report (1961-63), Ministry of Food and Agriculture (Department of Agriculture,) pp. 204, 205.

per hectare during the period 1960-61 to 1962-63. In West Godavari, if the figure for Rabi 1962-63 alone is taken, the yield rate was higher by about 3.0 quintals per hectare compared with the Rabi yields of the previous year.

Not only are the results in the I.A.D.P. blocks tending to be better than before, they are tending to be better than what they are in areas neither participating in the programme nor basing their credit on any production plan.

Yield Rates at Farms participating and not participating in the Package Programme, 1962-63

(average yield in quintal per hectare*)

Areas	Wheat		Gram		Rice	
	Parti-cipants	Non-par-tici-pants	Parti-cipants	Non-par-tici-pants	Parti-cipants	Non-par-tici-pants
Aligarh	15.0	12.1	13.5	11.4	-	-
Pali	13.8	8.8	-	-	-	-
Ludhiana	19.4[1]	15.8[1]	10.1	9.6	-	-
Shahabad	10.0	6.7	6.5	6.0	-	-
Raipur				~~9.8~~	9.8	7.7
West Godavari					15.4[2]	13.6[2]
Thanjavur					15.2[3]	13.1[3]

* 1 hectare = 2.47105 acres; 1 quintal per hectare = 1.08425 mds/acre.

1. Wheat (pure)
2. Rice (First crop)
3. Rice (Kurvai)

Source: Bench Mark and Assessment Survey under the I.A.D. Programme: Summary of the results, Directorate of Extension; Union Ministry of Food and Agriculture.

It will be seen from the table that in all the package districts, the yield rates were higher for the participants than for the non-participants. Perhaps one year's experience may not be enough basis for a generalisation. But the fact that better results were obtained for most categories of cultivators and for almost all the I.A.D.P. areas is also quite significant.[16] Moreover, the I.A.D.P. experiment is still in its infancy. With maturity, experience and better administration, it should pull up agricultural productivity amongst the participants very much higher than what has been possible in the brief period for which the programme has been in operation.

Thus an important element in our credit policy for the agricultural sector should be that credit is as far as feasible linked up with production plans of the borrowers and is duly supervised. To be fair to the Reserve Bank, it is itself emphasising this need in our credit policy now. 'Of special importance', the Directors of the Bank say in their Report, '...... are the implementation of rational loan policies geared to production requirements .... the promotion of cooperative marketing and processing suitably linked with credit and the employment of adequate and trained personnel in cooperative departments and institutions.'[17] But this requires drastic change in the perspectives and attitudes of cooperative credit institutions and in the administrative set up of Governmental agencies engaged in

16. For reasons of shortage of space and also because they do not concern us here, the details are not being mentioned. They can be found in the surveys from which the data for the table above have been taken.
17. op. cit., p. 1031.

the task of economic development of the agricultural sector. In particular, credit will have to be thought of as part of an integrated scheme of rural development rather than as an input capable of producing results entirely on its own.

A second need of our credit policy is that it should be particularly oriented towards the small and the medium cultivators. There are three reasons why that should be so.

The first has already been hinted at. It is related to the desirability of bringing down the general structure of interest rates in the rural sector as against that structure which pertains to institutional credit only, and on which monetary policy seems to have concentrated up till now. We have analysed why these are the small and the medium cultivators (amongst cultivators, they are important; however, if the entire rural population is taken, landless labourers and small artisans would be no less important) who matter most in setting the pace for the level of non-institutional interest rates in the rural sector.[18] We are not aware of the present position but some years ago when the All-India Rural Credit Survey submitted its report, facts did appear to agree with our suggestion.

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18. See pages 331-377.

Variations in Interest Rates in the Unorganised Money Market in India, according to Type of Region, Fiscal year 1951-52

Level of Interest Rates*	Number of Districts		
	Subsistence	Monetised	Commercialised and monetised
Very high	10	5	0
High	9	4	2
Medium	7	5	3
Low	1	6	8
Very low	0	8	7

* The level is determined by the proportion of borrowing (excluding borrowing at unspecified rates of interest) at rates of 18 per cent or more to the total borrowing from the principal private credit agencies. Very high level is where the proportion is 93.7 per cent, high is 77.0 per cent, medium is 54.3 per cent, low is 23.4 per cent and very low is 3.9 per cent.

Quoted in 'Interest Rates Outside the Organised Money Markets of Under-developed countries'; U Tun Wai, I.M.F. Staff Papers, November, 1957, p. 100.

The table shows that in districts where the subsistence sector predominates, rates of interest are the highest. In districts which are monetised, the rates would not be as high while in districts which are both monetised and commercialised, they would be even lower. If we assume that monetisation and commercialisation go with the level of prosperity of the cultivators, we can take this to mean that as we come to areas which have more prosperous cultivators, the level of interest rates declines. To operate on the general structure of interest rates in rural areas, therefore, we need to raise the level of propserity of the small and the medium cultivators. And this we cannot do unless our credit policy is particularly oriented towards them.

There is another reason why the small and medium cultivators should be a principal concern of our credit policy. The return they are likely to yield for comparable amounts of credit, should, at least in the beginning, be larger than what the big cultivators might yield. We might recall the report of the Rural Development and Credit Project in the Mehrauli block again.[19] This report had stated that during the period of the supervised credit programme, the increase in gross farm income per farm was greater amongst the cultivators who operated 3 to 12 acres. While the cultivators operating less than 3 acres got an additional return of Rs 70.7 per acre, those operating more than 15 acres got an additional return of Rs 15 per acre only.

Of course, an isolated experiment such as this cannot again be the basis of generalisation for the whole country but if one attempts an explanation of its result, one might say that such results should not be unexpected in most cases of supervised credit. The main cause behind smaller additional returns on large farms might be that the cultivators are already using the inputs, and techniques which supervised credit is supposed to emphasise. On the other hand, small and medium cultivators might use those inputs and techniques only when credit has been suitably geared to their production plans. This difference in the technological content of comparable amounts of credit for the big cultivators on the one side and medium and small cultivators on the other should be reflected in the marginal returns on supervised credit available to them.

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19. See page 400.

A third argument, which is so obvious that we tend to miss it, in favour of giving priority to small and medium cultivators in credit policy is related to the fact that they constitute an overwhelming proportion of our farming population. As a National Sample Survey Report on Land Holdings suggests, households owing between 0.05 and 0.99 acres constitute 15.11 per cent of total households while those owning between 1 and 2.49 acres constitute 13.87 per cent. The proportion of households owning between 2.50 and 4.99 acres is 13.66 per cent and that of households owning between 5.00 and 9.99 acres is 12.87 per cent. Including the households owning between 0.01 and 0.04 acres, the proportion of households owning less than 10 acres would be 65.29 per cent of the total. This proportion would rise to 70.41 per cent if households owning between 10 to 14.99 acres are also included. (Provided we add the 22 per cent households, shown in the table as owning or operating no land or land of a smaller size than 0.01 acres, the proportion of the poor would rise to 92.41 per cent of the total number of households). On the other hand, the proportion of households owning 15 or more than 15 acres would be 7.59 per cent only.

Percentage distribution of estimated number of Households and of Area Owned by Size level of Household Ownership.

		Area of holdings (acres)	Percentage distribution of ownership holding	
			Households	Area
0.00*	-	-	22.00	-
0.01	-	0.04	9.78	0.04
0.05	-	0.09	2.74	0.04
0.10	-	0.49	6.12	0.36
0.50	-	0.99	6.25	0.94
1.00	-	1.49	5.29	1.37
1.50	-	2.48	8.58	3.56
2.50	-	4.99	13.66	10.46
5.00	-	7.49	8.16	10.59
7.50	-	9.99	4.71	8.63
10.00	-	14.99	5.12	13.17
15.00	-	19.99	2.66	9.78
20.00	-	24.99	1.43	6.79
25.00	-	29.99	1.07	6.22
30.00	-	39.99	1.07	7.77
40.00	-	49.99	0.50	4.68
50.00	-	74.99	0.55	6.87
75.00	-	99.99	0.12	2.07
100.00	-	249.00	0.16	4.79
250.00	-	499.00	0.02	1.19
500.00 and above			0.01	0.68

* Households owning or operating no land, or land less than 0.05 acre are shown against this size level.

Source: National Sample Survey Report on Land Holdings, Rural Sector quoted in 'Rural Incomes in India': P.C. Bansil, Paper submitted to the Third Indian Conference on Research in National Income.

Thus the small and medium cultivators are numerically far more important than the big cultivators. Their economic condition being very poor, they form an explosive group and can make for severe political instability. If it is true that democratic economic planning would not work without the active sympathy and support of the main constituents of rural population, the case of small and medium cultivation has to receive a high priority.

Not that credit facilities by themselves would be enough to create in them all the enthusiasm which India needs at the present stage of her economic and agricultural development. As the National Sample Survey data (Table above) show, as much as 9.78 per cent of the cultivator households own a mere 0.04 per cent of total land holdings. The next 15.11 per cent having holdings between 0.05 and 0.99 acres own 1.34 per cent whereas another 13.87 per cent having holdings between 1 to 2.49 acres own 4.93 per cent of the total. The proportion of area held by 13.66 per cent of the households owning between 2.50 to 4.99 acres is 10.46 per cent while that held by 12.87 per cent of the households owning between 5 to 9.99 acres is 19.22 per cent. The area held by 7.78 per cent of households owning holdings between 10 to 19.99 acres is even a higher proportion of the total i.e., 22.95 per cent. But the most glaring aspect of maldistribution is revealed when we consider households owning 20 or more than 20 acres of landholdings: a small 4.93 per cent of households owns as much as 41.06 per cent of the total area.

Therefore, reform leading to a fairer distribution of land in rural areas may be an even more powerful factor creating enthusiasm amongst the small and medium cultivators than a credit policy

particularly oriented towards them.

Maldistribution of land may be the chief reason behind why 'despite all the land reform measures that have been undertaken in India since Independence ...... tenancy is very much more widespread now than official statistics would have us believe.'[20] If the amount of land with the cultivators, which is the main and in most cases the only source of livelihood for them, is inadequate, they would, laws or no laws, try to lease it in from those who have it in plenty. It may be for this reason that 'the effect of ..... reforms has been in part to drive some forms of tenancy underground and make them even more oppressive than otherwise (such as when they take the form of informal crop-sharing arrangements). If all these formal and informal arrangements are taken into account, it is likely that as much as 50 per cent of the total cultivated area is now under one form of tenancy or another.'[21] It is obvious that in unequal economic conditions between tenants and landlords, the former are exploited in such variety of ways that they are left with little enthusiasm to try to raise agricultural productivity.

Even in respect of the I.A.D.P. areas where credit is tagged on to production plans, the need for reform in the land tenure system has been emphasised. It is said that Mr. Ladejinsky who came as a Ford Foundation expert to report on tenurial conditions in the I.A.D.P. areas found that in four out of the five districts which he visited, the tenurial situation was not conducive to a successful implementation of the package programme.

20. 'Factors Responsible for Low Productivity in Agriculture', K.N. Raj, The Economic Times, October 7, 1964.
21. Ibid.

In fact in two districts, Tanjore in Madras State and West Godavari in Andhra Pradesh, the situation was quite bad in the sense that about 50 per cent farmers or more cultivated wholly or partially leased lands, mostly on oral leases.

If a faulty tenurial system can be a handicap in the few areas where production and credit are coordinated, in the rest of the country it should be a far greater handicap.

That land reforms would have a direct bearing upon the credit policy which we are suggesting here is another argument why they should be treated as an urgent and important matter. With very small landholdings and with leased in land, most cultivators find great difficulty in procuring finance from cooperatives because the latter insist upon their own standards relating to loan eligibility and security. The I.A.D.P. Report has expressed the hope that in package areas cooperatives would liberalise some of the standards relating to loan eligibility, security etc.[22] However, while hoping for improvement from that end, cannot we do something at the borrowers' end so that the cooperatives are compelled to lend to them more liberally than before? If land reforms enable our cultivators to be owners of a respectable minimum of land which they can call their own, at least a part of the gravitation of our credit policy towards them would become automatic.[23]

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22. op. cit., p. 212.
23. What we have said here assumes that the holdings would be, by and large, individually held. This assumption can, however, be questioned. Professor V.M. Dandekar thinks that the system of individual peasant holdings does not meet many requirements of economic growth and 'puts a ceiling on individual achievement and enterprise, depresses the agricultural sector and makes it politically weak'. In his view, a structure 'composed of large production units managed not on capitalist princi-

(Continued)

As in an under-developed economy generally, so in its rural sector, credit supply cannot be pushed too far without engendering inflationary pressures. Therefore, credit policy needs to be backed by effective measures aimed at mobilising savings of the rural population.

One way of doing it, as we have already suggested, is letting the cooperatives raise their deposit rates. If considerations of an unprofitable spread between the deposit and the lending rates are an obstacle to this being done, the Reserve Bank might, as an experimental measure, agree to subsidise the cooperatives to the extent of their loss on this account. As long as the inflationary impact of the subsidy is less than the disinflationary impact of savings, there may be nothing wrong in continuing with the experiment.

However, one possibility we have to guard against high deposit rates may benefit the big lenders and yield them extra rentier income. To deal with this possibility, we might try to relate deposit rates to the status of lenders (as measured by the size of their holdings, size of their families etc.) classified in two or three broad categories. This could help to cut out the

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(Continued from previous page)
ples but for collective good' and offering 'a large net work of institutions, where the enterprise and ability of individuals may find the fullest scope and where it may be amply rewarded' should be more preferable. (See his paper 'Economic Theory and Agrarian Reform', reprinted in Agriculture in Economic Development, Carl Eicher and Lawrence Witt, McGraw-Hill Series in International Development, 1964).

A land tenure system such as the one suggested by Professor Dandekar would make emphasis on small and medium cultivators in credit policy redundant but that policy would still have to be production-based and production-oriented.

rentier income of the big lenders. But a differential deposit rate policy, in the present state of the administrative efficiency of our cooperatives, might be difficult to enforce so completely as to cut out that rentier income altogether. And so it might become inevitable to take away the remaining rentier income through taxation. Even when a differential deposit rate policy can cut out rentier income unaided by taxation, the tax weapon would need to be vigorously applied in the agricultural sector. As in the rest of the economy, so in this sector, medium and long term finance should be sought to be raised through savings rather than created money. And it will certainly be too much to suggest that the entire of such finance can be got through the voluntary response of the people to the interest inducement.

CONCLUDING OBSERVATIONS

CHAPTER 22

CONCLUSION

It is basic to the discussion of any economic policy that we are clear about the background in which it has to operate. And since no single economic policy would do for all backgrounds, under-developed countries cannot evade the responsibility of evolving their own economic policies.

Monetary policy being merely an element in the general economic policy of a country, whatever applies to economic policy applies to monetary policy as well.

What sort of a background should we postulate for an over-populated under-developed economy? One answer would be: that which exists. But no under-developed country which knows how to go about its business would accept the status quo and not think in terms of what should be, namely, a background which can assure maximum economic development in the shortest possible time. India's decision to plan her economic development and not to leave it to the bare forces of the market should be understood as an attempt to create such a background.

However, once the background of a planned economic development is assumed, the concept of a mixed economy ceases to have the same connotation which it will have in a context where economic development is not the responsibility of a central planning authority. For this reason, what we say and feel about the satisfaction of

the private entrepreneur in the familiar type of mixed economy would be wholly misplaced in the type which grows in the background of a planned economy like India's. And the private entrepreneurs in such economies have to learn to think in terms of incentives which can be permitted within the overall interests of the economy and which may not be the same as the incentives their counterparts enjoy in more fortunate parts of the world.

Take, for instance, the issue of consumption control. Under-developed countries would require that every bit of the extra income of the profit earners is reinvested. Take another issue, namely, that of inventories. In view of the fact that economic growth in such countries is likely to be unbalanced in the earlier stages and there may be shortages of various kinds, traders may have to be prevented from building up inventories as freely as is done in developed countries.[1] Further, the entrepreneurs are expected to fall in line with national priorities in investments rather than go where 'incentives' would take them.

These and many other considerations which have a bearing on the nature of the mixed economy under-developed countries would tend to have should be reflected in their economic and monetary policies also. Otherwise, those policies would not only be misplaced, they would be even damaging to their best interests.

One such policy arises out of the view that money can force the pace of development, and therefore, an underdeveloped country should not fear being liberal in the matter of money creation. The truth of the matter is that where the State does not assume direct

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1. Anti-hoarding ordinances promulgated in India in the context of the current food crisis are a case in point.

responsibility for economic development and it is largely dependent upon the initiative of the private entrepreneurs, the least it can do is to assure that the efforts of the latter are not impeded. One such assurance would be to let them have money as freely as can be possible. As for whether investments would or would not be worthwhile, the private entrepreneurs knew their business well enough to be meddled with. In fact if in the past their investments produced happy results, there is every reason to hope that they would so now, as well.

However, where an economy decides even what the private entrepreneurs would invest, there is no reason why we should be so solicitous in the matter of money creation.[2]

There is another aspect to the policy of money being made the pace-setter for an economy. Money serves as a pace-setter in situations where unemployment coexists with an idling stock of capital, where returns from capital tend to decrease, where additional employment synchronises with a commensurate increase in the supply of consumers' goods, etc.

The Indian economy has certainly a lot of unemployment. But it has no idling stock of capital nor does additional employment in the economy synchronise with a commensurate increase in the volume of food and other essential commodities. For India, therefore, liberal money policy would not have much use unless we have directed it at utilising labour in such a manner that the use of capital is, as far as possible, minimised; also unless we have directed it at increasing production of essential commodities.

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2. In all of India's Plans, quotas of investments for the public and private sectors are separately fixed.

But capital-saving techniques are what a cheap money policy may not encourage at all. In fact, the techniques prompted by low interest rates might be more capital-using than capital-savings. As for increasing consumers' goods supply, cheap money policy may handicap the efforts by diverting investors to speculative investments.

Thus a liberal money policy in under-developed countries would have nothing to recommend it except that it forces people to save through rising prices. But accelerating economic development through inflation may not be a very wise policy. In a study of the issue presented to a Conference of the International Economic Association and recently published, Professor Ellis says that 'the number of economists who had, according to their own account, observed unfavourable effects of inflation upon development very greatly exceeded - perhaps 5 or 6 multiples in the sample covered..... the number of persons who held the contrary view'.[3] According to him, 'those whose findings were adverse to inflation in the growth process included numerous representatives from Latin American countries, where experience with inflation has been more extended in time and number of cases. Included amongst these observers were representatives of international agencies, national development, finance and banking institutions, as well as academic economists. The same breadth of the sample of observers marks the experience

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3. 'Price Stability: The Conflict between Growth and Control of Inflation'; Howard E. Ellis, Economic Development with Special Reference to East Asia, I.E.A., 1964, p. 267.

with inflation outside Latin America'.[4]

Once again, the difference between the Keynesian background for which inflation was suggested and our own has to be noted. Having said that removal of unemployment would require reduced real wages (since more employment means lower marginal productivity and, therefore, lower real wages) and having criticised the classical view that real wages should be reduced through a reduction in money wages, Keynes had no choice but to suggest policies which raised prices vis-a-vis money wages. But with wages of labour at subsistence levels in under-developed countries, this can set in motion a wage price spiral even in conditions of unemployment - a possibility which the 'General Theory' did not appear to regard as likely because of its assumption that in less than full employment situation, wages of labour would normally contain a rent element whose loss labour may not ordinarily grudge.

If savings have to be forced out of the people in the interest of a speedy economic development, it might be better to do that through taxation rather than through monetary policy since taxation would be less wasteful and more discriminating. However, this would necessitate rationalising the tax structure in such a way that it falls more directly on consumption than in the case where consump-

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4. Ibid.
Professor Ellis thinks that a considerable number amongst those who have spoken favourably of inflation in the context of economic development regard it more as an inevitable accompaniment of growth and less as a desirable way of bringing it about. 'It might be legitimate' he adds, 'to say that these observers are not presenting a favourable case for inflation but rather a case for practical policies which would make for the attainment of development without the costs and disadvantages of inflation'. 'In the remaining number of persons who actually ascribe a definable positive function to inflation', he goes on to say, 'nearly all have made the argument general; they have not asserted its validity for a given country and a given time'.

tion is sought to be reduced through the usual income and indirect taxes.

All these considerations point to the need for money being dear rather than cheap in the under-developed economies. They further imply that the task of monetary policy in these economies is greatly limited and money is one of the many inputs rather than the most important input for development; its production has to be coordinated with the other inputs of the economy. If the supply and use of other inputs is planned in advance, that of money should also be planned in more or less the same manner. Thus over-populated under-developed countries should not only be for a dear money policy they should try to make increases in their money supply a part of the general process of planning in the economy.

But this task cannot obviously be done by the <u>ex-post</u> approach which central banking authorities in these economies have been adopting in their monetary manipulations - that is, it is only when actual prices have already begun to get out of hand and the disease has become embedded that they try to do something about it. Such an approach may not matter in countries where the distributive machinery of the economy can well protect the peoples' interest against inflation, where every point of the monetary organisation can feel the brake without much loss of time and where, by and large, the government does not have to be selective about investments and to fear the arbitrariness which is involved in first letting things happen and then suddenly trying to stop them.

In an economy where there is no private sector and the techniques to be adopted in production are determined by the Planning authority itself, cost of credit may be much less important than

the availability of credit though even the Planning Authority would, for a rational allocation of capital, have to assume a rate of interest which reflects capital scarcity. However, in economies where a private sector exists and where it is as big as in India, both the availability of credit and the cost of it may have to be treated as being of equal importance.

We evidently assume that the demand for credit is not given. For if that were to be so, and the amount of credit which monetary authorities are going to make available is also known, the rate of interest would not need to be determined in accordance with policy, dear or cheap money policy, whatever it is; it will be just what can agree with the given demand and supply conditions. But where demand for credit needs to be controlled and regulated, this argument would not apply. For such conditions, therefore, both a suitable cost of credit policy and a planned supply of credit would be desirable.

Now a reversal of a liberal money attitude should not be interpreted to mean an assurance of price stability. That would, as we have seen earlier, depend upon a complex set of factors such as general consumption policy, marginal propensity to consume of the profit earners, the terms of trade between industry and agriculture, the self-consumption in the agricultural sector, the marketable surplus of consumers' goods, the capital intensity of investments, the income elasticity of demand for the exports of our economy etc.

All that dear money and planned money supply would mean is that money itself would not be a source of inflation which it inevitably tends to become when under-developed countries choose to adopt

a liberal money attitude. However, with dear money, capital would be less irrationally allocated, investment priorities would not suffer much distortion and excess demand conditions would be greatly reduced. Alongwith a tax structure aimed at regulating consumption directly, which has, in any case, to be devised if investment rate is to be maximised, such monetary policy should assume a better prospect for speedy economic development with stability than liberal money policy would.

But a monetary policy - fiscal policy combination of this type would require certain conditions to be fulfilled.

One such condition would be the enunciation of a national consumption policy. Such a policy would help the fiscal authorities in moulding taxation in such a manner that the consumption of the various categories of people and of the economy itself is kept within appropriate limits. It will also enable the fiscal authorities to get an idea of the maximum amount of real resources which the economy can spare for development. Once the real flows of fixed investments are known and assured, an assessment of the money balances, the economy would require, could be more easily made than in present conditions.

But a national consumption policy may not be enough assurance of price stability unless production and stocks are also suitably correlated. And so in addition to such policy, we might need a policy defining the permissible accumulation of stocks by producers and traders as well.

How greatly indifferent can monetary authorities be towards the factor of stocks is illustrated by the interesting Bill Market Scheme which the Reserve Bank of India introduced in the early

fifties. Perhaps, it did not occur to the Bank that though technically the policy of extending the short period credit market[5] through self-liquidating usance bills might be correct, economically it might be damaging if extension of credit led to the holding of more stocks by the traders. Not that encouraging traders to hold more stocks is always undesirable but it is certainly difficult to understand that encouragement when it is given in the face of such general shortage of commodities as is characteristic of all under-developed countries including India, to-day.

It appears that the Reserve Bank did change its attitude towards the scheme later but it is not clear if it did so on the ground that it was economically untenable. At first, the lending rate under the scheme, started in January 1952, was half a per cent lower than that for securities, but later it was gradually raised to 3¼ per cent in March, 1956 and to 3½ per cent in November 1956. On February 1, 1957 the Government raised 40 times over, the stamp duty on usance bills and thereby pushed up the cost to the borrowers under the Bill Market Scheme to 4 per cent which was half a per cent higher than the rate for Government securities. In May 1957, when the Bank rate was also raised to 4 per cent, the borrowing rate under the Bill Market Scheme was still higher by 0.2 per cent than the rate for Government Securities since the stamp duty on usance bills was not so much cut down as to neutralise the effect of a higher Bank rate.

Now an ex ante assessment of the amount of money the economy would need is by itself no guarantee that such an amount would, in

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5. Evolution of Central Banking in India: Sir B. Rama Rau, 1960, pp. 31-34.

fact, be created. As long as money creating institutions are in private hands and supplying money is a profitable business, it will be difficult to work out a 'planned' money policy. In fact if a policy of high interest rates results in a growth of savings and other time-deposits of commercial banks, no practical variation in the reserve ratios or selective credit control devices might help in controlling the banking system. This would be particularly so when users of credit are also interested in more credit being created.

For a successful operation of a planned money policy it appears inevitable, therefore, that commercial banking institutions are nationalised.

Another institutional change implied in our suggestions would be a better coordination between institutions mobilising savings and those financing the long period investments. As a first step towards that coordination, monetary authorities should avoid taking interest in long-term financing of investments since such investments should be saving rather than created money financed. As a second step towards that coordination, the Government might attempt reducing the number of institutions which are engaged in the task of mobilising savings and financing long-term investments. In particular, the number of the latter needs to be greatly reduced. In so far as it may be too much if the savings and investment functions are combined in the same institution, the Government should set up two such separate savings and investment organisations as are working in close collaboration with one another.

In the agricultural sector, credit policy would be partly but not entirely related to the tenurial system. For, after all,

in any system of land tenure, credit has to be related to a plan of production if it is not to get misdirected and produce inflationary conditions. But the task of relating credit to production plans is not such as would be done without suitable organisational or institutional changes in the rural sector. The Intensive Agricultural District Programme in India is being watched with great interest but one does not know how far it will be possible for all farmers in the country to draw inspiration from it. If the inspiration does not work or at any rate, does not spread as far and widely as we hope it would, we may be obliged to think in terms of experiments which do not agree with a land tenure system in which individual peasant holdings predominate. However, as long as we have the latter system, credit policy would need particularly to focus attention on the small and medium cultivators who make such an overwhelming percentage of our farming population.

The notion that the agricultural sector is too poor to save for its development can be no more acceptable than the notion that an under-developed country itself is too poor to do that. At every level of development, the rate of savings can and should be sought to be accelerated. In India, however, judging by the rates which cooperatives offer on their deposits, that does not seem to have been done in the rural sector. Perhaps, the Reserve Bank has allowed the deposit rate to be determined by the lending rates of the co-operatives, which is certainly a sound banking principle. But a vigorous savings policy in the rural sector might require suspending this principle in favour of an experimental subsidy on deposit rates. Lest higher deposit rates might yield rentier income to the 'big' savers, a differential deposit rate policy may be worth attempting.

however, since interest inducement may not go far in accelerating savings, we should be prepared to apply a vigorous tax policy in the rural sector as well, for the purpose of savings mobilisation.

The emphasis which we have given to taxation policy and institutional changes may reduce the significance of monetary policy so considerably that one may wonder whether it is really worthwhile discussing that policy at all.

Now while the basic idea behind the thesis presented in this work is that in under-developed countries monetary policy should have no particularly active part to play so far as resource creation or even resource mobilisation is concerned, once that is accepted, a new setting for whatever limited role monetary policy can play has got to be provided. It is for the establishment of this setting that we require the sort of institutional changes which we have suggested above.

The purpose of our arguments would be completely misunderstood if a stricter control on money supply is taken to mean the end of the story; in fact, it is just the beginning of it. If the progress towards improving the economic well-being of the people in under-developed countries has to be rapid, and the illusory input of money has to be replaced by real savings, a lot in the direction of fiscal policy and institutional changes will naturally need to be done so that following the abandonment of a liberal money approach the rate of investment does not suffer.

It remains to be seen how India's planners face the challenge of development with stability in the coming years.

Up till now some 'suction pumps drawing inflationary funds out of circulation'[6] also helped them a little. Between 1954-55

6. 'Inflation Caused by Over-investment'; B.R. Shenoy, Supplement to Capital of 20th December, 1962, p. 49.

and 1961-62, whereas the aggregate of the budget deficits and increase in bank money amounted to Rs 2669 crores, the money supply rose only by Rs 1,256 crores because the general purpose foreign aid and the currency reserves enabled the return of some inflationary funds to the Reserve Bank through the purchase of foreign exchange sold by the Bank.[7]

The U.S. commodity assistance received under both P.L. 480 and P.L. 665 might also have proved deflutionary since while the total assistance under this programme during the period 1956-57 to 1961-62 was Rs 663.5 crores, the actual amount disbursed was Rs 243.5 crores.[8] To quote from a Reserve Bank study, 'Assuming that during this period, the stocks of imported commodities did not change and the Government did not subsidise the sale of food to the public and treating the U.S. Embassy's time-deposits as Government deposits, the net contractionary impact on the net bank credit to the Government and money supply of all the transactions relating to the U.S. Commodity assistance would be Rs 633.5 crores, minus Rs 243.5 crores, that is, Rs 390 crores'.[9] We have no information about the extent to which these assumptions were true during the period referred to in the Reserve Bank study. But if the food situation in India remains intractable for some more time and stocks of imported food are increasingly drawn into the market as at present, the contractionary impact of the U.S. commodity assistance would tend to disappear through time. As for the currency reserves, we almost

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7. op. cit., p. 48.
8. 'Effects of the United States Commodity Assistance to India on Money Supply', R.B.I. Bulletin, January, 1963, p. 27.
9. Ibid.

exhausted them as far back as October 1962 when they were a mere Rs 8 crores more than the legal minimum.[10] On the other hand, the prospects of our getting more general purpose aid as against tied aid do not appear to be particularly bright.

With these 'suction pumps' weakening, with some important Third Plan achievements likely to be about 20 per cent short of the target, with prices rising currently at a fantastic rate and the Fourth Five Year Plan proposed to be equal in size to the sum of all the plans that have gone before, the challenge to India's planners and monetary authorities is going to be very formidable indeed. It will be unfortunate if in their zest for economic development they forget that a threat to price stability could mean a threat to economic development itself.

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10. Shenoy, op. cit., p. 49.

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